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OVERSIGHT OF GENERAL REVENUE SHARING

HEARINGS

BEFORE THE

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INTERGOVERNMENTAL RELATIONS

OF THE

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GOVERNMENTAL AFFAIRS
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CONTENTS

Page

Opening statements:
  Senator Durenberger 1
  Senator Sasser 3

WITNESSES

TUESDAY, APRIL 5, 1983

Richard P. Nathan, Princeton University 4
Edward M. Gramlich, professor of economics and public policy, University of Michigan 14
Arthur R. Goldbeck, Associate Director, General Government Division, General Accounting Office, accompanied by Jerry Fastrup, GAO Evaluator 30
Richard A. Snelling, Governor of Vermont, on behalf of the National Governors' Association 48

THURSDAY, APRIL 6, 1983

Hon. Frank Horton, U.S. Representative in Congress from the State of New York, on behalf of the Northeast-Midwest Coalition, accompanied by John Duncan, minority staff director, House Committee on Government Operations 81
Bob Honts, Travis County Commissioner, on behalf of the Texas ACIR; John Shannon, assistant director, taxation and finance section, Advisory Commission on Intergovernmental Relations, accompanied by Albert Davis, senior analyst; and Douglas Clark, assistant director, federal-provincial relations division, Canadian Department of Finance 98
Robert Orth, legislative and intergovernmental relations chairman, Ramsey County Board of Commissioners, on behalf of the National Association of Counties; John P. Rousakis, mayor of Savannah, Ga., on behalf of the U.S. Conference of Mayors; George Miller, president of the National Association of Towns and Townships; and Chris Lindley, city councilman, Rochester, N.Y., on behalf of the National League of Cities 160

ALPHABETICAL LIST OF WITNESSES

Clark, Douglas:
  Testimony 98
  Prepared statement 149
Davis, Albert: Testimony 98
Duncan, John: Testimony 81
Fastrup, Jerry: Testimony 30
Goldbeck, Arthur R.:
  Testimony 30
  Prepared statement 36
Gramlich, Edward M.:
  Testimony 14
  Prepared statement 24
Honts, Bob:
  Testimony 98
  Prepared statement 121
Horton, Hon. Frank:
  Testimony 81
  Prepared statement 88
Lindley, Chris:
  Testimony 160
  Prepared statement 181

Page
Miller, George:
  Testimony 160
  Prepared statement 178
Nathan, Richard P.:
  Testimony 4
  Prepared statement 11
Orth, Robert:
  Testimony 160
  Prepared statement 174
Rousakis, John P.: Testimony 160
Shannon, John:
  Testimony 98
  Written responses to questions asked by Senator Levin 111
  Prepared statement 137
Snelling, Richard A.:
  Testimony 48
  Prepared statement 61

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

"Fiscal Capacity as a Method of Allocating Federal Grant Funds," working papers on the New Federalism, Texas Advisory Commission on Intergovernmental Relations 183
"City Fiscal Conditions in Fiscal Year 1983: Dark Clouds on the Horizon," by Francis Viscount, a policy working paper by the National League of Cities, December 1982 207
"The Importance of GRS Continues and the Need for Renewal Increases," by Francis Viscount, a policy working paper by the National League of Cities, January 1983 226
Fact sheet on S. 41: State and Local Fiscal Assistance Act Amendments of 1983 257
Fact sheet on S. 700: Expanded Revenue Sharing Program 258
Statement of Mayor Edward I. Koch 262

OVERSIGHT OF GENERAL REVENUE SHARING

TUESDAY, APRIL 5, 1983

U.S. Senate,
Subcommittee on Intergovernmental Relations,
Committee on Governmental Affairs,
Washington, D.C.

The subcommittee met, at 9:30 a.m., in room SD-342, Dirksen Senate Office Building, Hon. Dave Durenberger (chairman of the subcommittee) presiding.

Present: Senator Durenberger.

OPENING STATEMENT OF SENATOR DURENBERGER

Senator **Durenberger**. The hearing will come to order. This morning the Subcommittee on Intergovernmental Relations is conducting the first of 2 days of oversight hearings on the general revenue sharing program, which expires on September 30, 1983. The reauthorization process is well underway. Back in January, I introduced S. 41, which is a simple 3-year extension of the existing program, and that bill now has 72 cosponsors in the Senate. Congressman Frank Horton, from whom we will hear tomorrow, has the House companion, H.R. 616, with over 100 cosponsors.

In addition, there are several bills in both the House and the Senate that would go beyond a simple extension. Some make modest changes, such as increasing the authorization level or extending the authorization period from 3 to 5 years.

Others seek more substantial changes, such as bringing the States back into the program or changing the allocation formulas.

At least one bill that I know of—it happens to be one I introduced—would make even greater changes in the program in the hopes of using revenue sharing as the building block for continuing federalism reforms in the coming years.

These oversight hearings come in the wake of 3 days of intensive hearings in the House and four House field hearings. The Senate Finance Committee has also held its first day of hearings on reauthorizing the program, and I expect both the Senate and the House to hold at least one additional hearing before going to markup. It is my hope that we will see a reauthorization bill through both Houses and on the President's desk by July 4.

Now, this is a very tight time schedule, and it may mean that the best we can hope for this year is a short, simple extension of the program, done with the expectation of coming back immediately next year to consider seriously the varied proposed changes that I have mentioned.

Back when I introduced S. 41, I said that the overwhelming support for the bill indicated a simple reauthorization was the minimal acceptable alternative.

I have hoped that we would do better than a simple extension, but the need to reauthorize the program in a timely fashion could make it impossible to do more this year. Therefore, if it appears there will not be enough time this year to make significant improvement in the program, I do not feel it would be wise to make mere incremental changes and have them locked into place for the next 3 to 5 years.

If we are serious about improving general revenue sharing now is not too soon to get to work on it. These 2 days of hearings will look beyond a simple extension of the program. They will, in fact, look beyond simply bringing the States back into the old program, toward an entirely new program.

What we hope to accomplish in the next couple of days is to take a close look at the complex fiscal arrangements and the web of resource transfers between the Federal Government and State and local governments, what I call fiscal federalism. Of special interest will be the role that revenue sharing plays in this system.

We hope to go beyond the narrow view of fiscal federalism, which held our attention throughout the discussions of New Federalism last year. That debate was confined almost exclusively to Federal grants. But fiscal federalism encompasses much more than the direct transfer of Federal dollars through grants-in-aid. It is also a system of Federal borrowing subsidies to State and local governments in the form of a Federal tax exemption totaling somewhere in the neighborhood of $14 billion annually; and a $32 billion taxing subsidy in the form of a Federal tax deduction for State and local taxes.

So the universe for reform extends well beyond the $80–$90 billion in Federal grants, to a system that exceeds $135 billion a year.

Given this outline, we want to ask certain questions of the system as a whole: Is it effective in achieving the goals that we establish for it? Is it efficient in its use of scarce Federal resources? Is its overall effect distorting of local priorities? Is it a balanced system? And where does revenue sharing fit into a possible rebalancing of this system?

Over the past year I have asked myself these questions, and I have found the system wanting. It is considerably less effective in achieving important national purposes than it could be, and at the same time it greatly distorts State and local priorities; it is highly inefficient; it is unbalanced, with far too many categorical grants and too little emphasis on general-purpose fiscal assistance; and its overall distribution of Federal resources is inequitable.

S. 700 is an effort to address these problems by reordering the system, making a revised revenue sharing program a more central component. It puts States into a new revenue sharing program; it does not restore States to the old program. It dedicates 4 percent of the Federal individual income tax collections to revenue sharing to make the program predictable—to make it permanent—and to insure that it grows with the economy of the country; and it improves the allocation formulas to ease the most glaring fiscal disparities, the wide variations in the abilities of States in this Federal system to raise their own revenues. Attending to these fiscal disparities must be a national priority under New Federalism.

What I have in mind is not general revenue sharing as we have known over the past decade. I am talking about revenue sharing as a foundation for a genuine New Federalism. I have in mind a program that will take about $6 billion from the most inefficient Federal subsidy to State and local governments, tax deductibility, and move it over to the most efficient, revenue sharing. I have in mind a program that will guarantee to every State that if it taxes itself at a reasonable level, it will be able to provide an adequate level of public services under the New Federalism.

In short, the program I envision would offer State and local governments a new charter for the Federal partnership. I do not expect any of them to sign on the dotted line today. But I would ask them to explore the fine print with me in search of something we can all agree on.

I have a statement of Senator Sasser's that will be included in the hearing record.

[Senator Sasser's opening statement follows:]

OPENING STATEMENT OF SENATOR JIM SASSER

These hearings are very, very timely just now, with our country in the throes of a major recession. The revenue-sharing check that the Federal Government mails to 39,000 localities around the country every 3 months is a fiscal lifeline that I believe is very important to continue and strengthen. Yet, this important program may expire September 30 if it is not reauthorized promptly.

Fortunately, general revenue sharing (GRS) seems to have many supporters. Senator Durenberger's renewal bill, S. 41, has 72 cosponsors—more than two-thirds of the Senate at the present time. And it's no wonder. This well-established program has proven its effectiveness over the past 10 years. It is one of the least bureaucratic programs with the lowest overhead cost per dollar of aid ever created by the Federal Government.

In Tennessee, local governments have received $700 million in revenue-sharing assistance during the initial 9 years of the program. This money has been used for a variety of programs.

In Chattanooga, a medium-sized city of nearly a quarter of a million residents, $2.6 million of the $3.8 million total yearly allotment is used in the operating budget. The rest goes for vital capital projects.

It would take a 32-cent tax increase to replace the full annual revenue-sharing allocation. If the funds were not raised through the property tax, then services to Chattanoogans would have to be cut in proportion to the funding reduction.

For a city like Chattanooga, where the unemployment rate was 11.2 percent this February, the continuation of this funding is crucial.

In rural Lewis County, Tenn., where the unemployment rate last fall—at 28.8 percent—was nearly three times the national average, revenue sharing enables the county government to continue to provide essential services to its citizens.

In my view, the quickest way to help distressed communities such as these would be to augment the revenue-sharing subsidy for this year. That is the objective of S. 525, which I am cosponsoring to move up the quarterly revenue sharing payments so that local governments will get them sooner. And it is also the thrust of S. 735, which I support, which provides a one-time increase in the funding of general revenue sharing of 50 percent for fiscal 1983.

I think, it is important, to keep the momentum of general revenue-sharing renewal moving without allowing it to become entangled in efforts to make sweeping changes in the program. If a consensus can be reached quickly on major changes in revenue-sharing, then perhaps they should be considered. However, revenue-sharing must be reauthorized by September 30.

The need for revenue sharing is clear. I compliment Senator Durenberger for his tireless work in maintaining and improving this program. I intend to work closely with him to reauthorize and strengthen the general-revenue sharing program.

Senator DURENBERGER. Our first witness this morning is Prof. Richard Nathan of Princeton University. Professor Nathan served in both OMB and HEW in the Nixon administration and is a noted expert on revenue sharing. He has been head of the Brookings Institution revenue sharing monitoring project right from the beginning and is the author of several books and articles on the subject of revenue sharing.

Dick, we welcome you to the hearing.

TESTIMONY OF RICHARD P. NATHAN, PRINCETON UNIVERSITY

Mr. NATHAN. Thank you very much, Senator. It is a pleasure to be here.

This is the third time the revenue sharing program has come up for extension. The program began in 1972; since then $70 billion has been distributed—$300 for every person in the country. In my view, the program has been a success. Nevertheless, the value of revenue sharing payments has been greatly eroded in the decade since its enactment. A 1972 revenue sharing dollar has eroded, due to inflation and the elimination of the States from the program, to the point where its purchasing power is now 46 cents.

I have been a revenue sharing habitué—I was not sure how to pronounce that, but I did my best—both in government and out since the mid-1960's, and I have testified—and I do not know if I should admit this—on the original legislation and on both of the previous extensions. In my testimony today, I am going to deal first with your bill, Senator, S. 700, and with the overall setting for revenue sharing legislation.

Two of the central characteristics—and you alluded to them—and great strengths of American federalism are the dynamism and the diversity of the American federal system. American federalism is constantly changing; the greatest surprise that could occur under a new administration in Washington would be stability. We live with change as a steady state.

The Reagan administration, in my opinion, has achieved its greatest success in precisely this area: domestic policy and changing federalism. It has achieved success on four fronts: One, by advancing retrenchment policies in the domestic area, particularly in the first year; two, by changing the tone and mood of domestic policymaking in Washington—the change is quite marked; three, by fundamentally revising the Nation's welfare policies, although not many people realize this; and four, by devolving categorical grant-in-aid programs to the States, not to local governments under the block grants passed in 1981. The intergovernmental industry, as a result, is in a state of shock. It is in this setting that you are considering the reauthorization of the revenue sharing program. It is a gloomy time in Washington for State and local officials compared to past occasions on which revenue sharing legislation has come up for renewal.

Under these conditions, Mr. Chairman, I want to commend you for having presented a creative proposal, S. 700, for the extension of revenue sharing—a proposal that looks to the future. S. 700 contains important provisions that draw in an effective way on the extensive research that has been done on the revenue sharing program.

Mr. Chairman, I have a proposal that I want to make today, which is maybe a little bit radical, but I hope it will help in your deliberations. I would like to suggest that revenue sharing be reauthorized for 1 year—not for 3 years or 5 years—this year and that a special panel be created to report in 6 months on the elements of your bill, S. 700, and other ideas of a similar nature that require further and longer discussions and analysis before they could be adopted. Strategically and substantively it would make a great deal of sense this year to consider a 1-year extension, which would allow the time to give more attention to ideas like those which you have advanced for more fundamental changes.

Next year is likely to be a better year for federalism legislation. It could hardly be as inopportune as 1983. If the economy is stronger, it will be easier to make the case for the kinds of proposals in the Durenberger bill that require additional revenue. If the economy fools the experts again and is sluggish next year, that would provide an opportunity to use revenue-sharing legislation as a vehicle for targeted and countercyclical measures.

Such a simple 1-year extension would permit careful testing of the formula ideas in S. 700 plus other bills. This is essential in a political system such as ours, which is highly diverse. You never can quite predict what anomalous, counterintuitive result that will come from proposed formula changes. It is necessary, with the computer technology now available to us, to very carefully look at ideas for changes in a close and detailed way.

A 1-year extension would permit some sophisticated political probing to see if there is an opportunity to enact the two most far-reaching features of your bill, both of which I support: the trust fund to earmark 4 percent of Federal income taxes for revenue sharing, thus making it permanent and predictable and having it adjusted for inflation; and second, your proposal relating to the deductibility of State and local taxes, which is a very big subject to get into but one that I think we should get into.

A 1-year extension, Mr. Chairman, would also allow time to develop the necessary head of steam for putting the States back into the revenue-sharing program, as your bill does. I believe that the argument is stronger now for putting the States back into revenue sharing. The States, as the critical middlemen of American federalism, deserve to be given a larger role in American federalism in this period of retrenchment on the part of the National Government.

A 1-year extension would facilitate considerations of such measures as a targeted fiscal assistance supplement that recognizes the special needs of highly distressed communities. Several bills have been introduced to do this, including one you have introduced, for automatically triggered jobs and public works component of revenue sharing that would come into play when the economy falters in future periods. That makes a lot of sense on many grounds.

I realize that this proposal for a 1-year extension goes against the considerable effort made to win support now for a 3- or 5-year extension. Nevertheless, I think there are strong reasons for such a strategy, and I wanted to use this opportunity to put them before the committee.

Mr. Chairman, if I am not persuasive enough—and I have no illusions about this to be very honest—and 1983 turns out to be the year for a longer extension of revenue sharing, then the question that I think I should address is: What are the provisions of S. 700 and other new ideas that are desirable and could realistically be considered in the current Congress?

My answer would be three points: First, that detiering is a good idea. The GAO has studied this change. The same applies to changing the 145-percent maximum and 20-percent minimum, as your bill does and as we proposed in our first Brookings book on revenue sharing. I think there is a consensus on the need to make changes in that area. Third, if you are going to do either or both of these things, there need to be some extra funds to pay for a hold-harmless guarantee to be sure that nobody is hurt, that is, loses as a result of these two fairly straightforward changes that have been studied extensively.

I am less certain, Mr. Chairman, that in the short run the Congress should adopt the two-factor interstate system which you propose which uses the idea of an ACIR representative tax system as one factor. It is not altogether clear how well or how this idea would work in practice. The Secretary of the Treasury, under your bill, is assigned a high level of discretion. That makes me a little bit uneasy. However, I strongly agree with the intent of your bill, which, as you explained, to quote, would be "to ease fiscal disparities among the States." We definitely need to work on that aspect of the formula, and it would take time to do it. This subject is an area in which the idea of a 1-year extension where you could test and probe for changes of this kind would make a lot of sense.

I should conclude by saying that a decision not to continue at least the current version of the revenue sharing program would be the fiscal last straw for local governments. We are currently conducting a study in 54 governments around the country to assess the impact of the Federal budget cuts made in fiscal year 1982. Many local governments have been hard hit by the recession, by Federal aid cuts, and by tax and spending limits. As the most flexible form of Federal aid to localities, revenue sharing is a vital source of funds. It is the most stable manifestation of the compact between Washington and local governments that now exists. Its removal would have grave fiscal and federalism consequences.

Thank you, very much.

Senator DURENBERGER. Thank you, very much, Dick.

Let me ask you to draw upon your revenue sharing roots and the various branches that have developed over the last 10 years. I would like to have you put into a present and future perspective the rationale for revenue sharing. Because, if you go back to the roots, you will find some people claiming that GRS was a Republican decentralization theory. Or Walter Heller tells me that it was a way of disposing of that greatest of all dreads of the Keynesian economists, a surplus in the budget. And then some of us who were involved with Governors' offices back in the mid to late sixties understood that it was sort of a cry of frustration from State and local governments. We saw tax resources being sucked into Washington by inflation and an unindexed tax system. And if you go back even further, I am told, into the fifties, there were some who were making fiscal disparity arguments as a rationale.

Are there any other rationales that I might have missed as we examine the roots of general revenue sharing?

Mr. NATHAN. You have mentioned five rationales for the program. I think those are the main ones. That is a good list.

Let me comment on where we are today, and which of those rationales apply most strongly and mention one other point. Your first point about decentralization, strengthening State and local governments and changing the balance in the Federal grant system, a very important one, and is the basis on which I draw the conclusion that revenue sharing has worked.

Revenue sharing has done three things: As a Republican initiative in the seventies, it caused the Federal Government to continue to provide aid to deal with domestic public sector needs, but under New Federalism instruments. That new idea was an engine for more attention to domestic/social needs. No. 1.

No. 2, it did give local governments and State governments through the block grants and revenue sharing a way to play a larger role, and I think they have, in our political system. We see manifestations of that all the time. Sometimes we don't recognize changes because we are so close to them.

No. 3, it has been a source for stability. Local governments see everything changing all around them, and one thing they care about and they know about is they are going to have that core of flexible support in the form of revenue sharing and also CDBG aid. I see revenue sharing as having had a good effect in terms, not of just federalism, but of meeting domestic needs and also, as you pointed out, promoting balance in the role of State and local governments in our governmental system.

I think that your bill brings some additional points to bear that look to the future in a good way. You stress the equalization point which Walter Heller and Joseph Peckman always made. Their revenue sharing bill was proposed in large measure to achieve equalization. I don't think we have gone as far in that area, particularly among the States, as we should. There are new issues now having to do with natural resources in the wealthier growing States. The way your bill looks to formula changes that move toward a representative tax system, would bring that additional purpose of revenue sharing more fully into play.

The same thing is true of your point about the tax system.

In summary, I think revenue sharing has served three of the goals you listed quite well, and that your bill addresses two other goals which have not been addressed in as good a way in the past as they should be in the future.

That is one of the reasons why I hope other people will take a hard look at that bill and that those ideas will be widely discussed.

Senator DURENBERGER. The point you make relative to decentralization effort implies strengthening the Federal partnership and trying to balance it out. Obviously, you have found that we have been trying to accomplish in that, in this whole effort, a financial base for a New Federalism.

As you said, it seems that every President has a version of New Federalism, but this President, because of his background, because of the timing, because of his willingness to do those four things—the retrenching, the tone change, the welfare revision and the devolution—gives us an even greater opportunity if we recognize just exactly what the problems are that we are trying to resolve.

So as I look at this current system and I look at the role revenue sharing is actually playing today I ask "Does it—the overall system—do anything about fiscal disparities?" And the answer seems to be, "No, it does nothing." In fact, it may exacerbate them.

When I look at how well revenue sharing balances this whole system of fiscal federalism, as the program now exists, I really cannot see that it does much. It spreads too little too thinly. I don't know what it is doing, for example, to achieve national purposes when we just say, "Here is some money."

There are no ties on it, so certainly it is good from the standpoint of providing flexibility. When I compare that with some of the other parts of the fiscal Federal system, it seems to be a whole lot more flexible than categorical grants or block grants as we created them last year. It certainly seems to be more efficient than tax subsidies or tax exempt bond financing as a way of providing Federal assistance.

But I keep coming back periodically to that first weakness. I am sitting here as a Member of the Congress, and I presume that for every one of those dollars that I am raising, somebody is going to hold me accountable for spending; that I should be spending them on key national purpose; that I am running a $200 billion deficit, so I haven't got any money to begin with, which means I have to be especially careful to have some kind of a national purpose behind what I am doing. And then I come to the point where I turn to you and say, "Given all the good things about revenue sharing, but given this concern that theoretically we don't have the money, and this question of how we are going to achieve national purposes with general assistance money," is it really such a good idea to expand the notion of general revenue sharing and thereby, perhaps, abandon some other part of the system?

Mr. NATHAN. Let me comment first on your point about national purpose.

There often is an assumption on the part of the people who have worked in this field that Washington knows better what the national purpose ought to be and that somehow the electorate that picks people to represent us in Washington is a different electorate.

To be very direct about that, that is a position that is usually espoused by liberals who believe that a national government will do more and care more.

I think that that theory is called into question right now. Retrenchment is coming on much stronger from Washington than from any other level in our federalism. On social issues, the Reagan administration has been very consistent and very successful in cutting back welfare in a way that cuts people off the welfare system.

If you look at American Government, I think you will find that today and in past periods, it is often true that many of the initiatives for meeting social needs have come out of State governments and out of the community. Your State has a proud tradition of being innovative in dealing with community and domestic issues.

I think there is something very important about the Jeffersonian ideal of a community and the people in communities deciding what they want to do to meet needs in a community.

What our Federal aid system has to do is strike a balance. There are some areas where categorical grants are appropriate to do new things, where the new wisdom on how you do it is centered in just a few places and Washington should take the initiative.

There are some areas where block grants make a lot of sense. The community development block grant, which is for a certain kind of activity, but it also flexible, has been very successful in my opinion.

There are other areas in the grant system where we have entitlement grant programs, for example, for AFDC and medicaid. Lord knows, we need to do a lot of work and think hard about those troubled programs. Welfare dependence is growing.

What you have is a constant balancing act. There are some groups, like the ACIR, that tell us there is one way to make federalism balance that will be the right way for all time. I don't agree. Federalism is a constant adjustment process. It is the way we express values in our governmental system at many different points in the system. It is a very creative system, a very good system. Madison invented it and did the right thing a long time ago.

Now, the States need to be brought back into the system. The States are giving new leadership at a time when the local tax systems are squeezed and the Federal Government is pulling out of domestic areas.

I think we need a revenue-sharing act that would have two or three titles as an omnibus bill. One would be the basic program; one would be putting the States back in; one would be targeted fiscal assistance. I referred earlier to the problem of the growth of a dependent underclass population in older urban and rural communities. If you could enact targeted assistance as part of revenue sharing next year, under more auspicious conditions, that would be very important. It doesn't matter as much what the money is for, as that it goes to the right places. And the right places increasingly today are these fogotten enclaves that have large concentrations of, what I think it is appropriate to call, underclass populations, people that are very hard to help, people who have very deep problems. Revenue sharing can be a good instrument for urban policy.

Another reason I would like to see more money in revenue sharing, to answer your question, relates to your point about the deductibility of State and local taxes. Your proposal of a 1-percent floor of adjusted taxable income has a lot to commend it. If we could find a way to bring about those kinds of equity objectives as a trade for putting States back into revenue sharing and expanding the revenue sharing program on a countercyclical and a targeted basis, we would be doing a lot of things right in the grant system.

Omnibus federalism legislation that picked up on your ideas and involved not $5.9 billion but, as you proposed, $11.8 billion or more, in my opinion, could be a vehicle for making a number of very desirable changes that might be possible before an election. I think that next year is better than 2 years from now or 3 years from now. Public interest groups—I won't use the acronym—say, "we just want to get this money. We don't want to fool around; an old formula is a good formula."

But my feeling is that you can be reasonably confident that the local share of revenue sharing will continue at least at the current level, particularly if we are talking about next year just before an election. The interest groups involved really have more to gain. The cost-benefit equation is in favor of a strategy of trying to find a way to do some of these new things that you have proposed.

It wouldn't take new research, but it would take some further work to spell this out in a way that does two things: One, tests the appropriate formula instruments very carefully, and I think the representative tax system has some hard politics to it; and, second, develops ways to make the arguments to show why you gain by using revenue sharing as a vehicle for the next generation of domestic policy reforms.

Senator **Durenberger**. OK. I think you put your finger on a couple of the problems, and, I suppose, a couple of opportunities. The fiscal disparities issue, obviously, is a difficult one to deal with. Larry Williams almost beat John Melcher for the Senate out in Montana by running against Dave Durenberger on severance taxes. Now, John Tower is up for reelection next year, so I intend to help him out by going down to Texas and letting him run against me.

I think we ought to be dealing with the problems that we are not now dealing with, at least not without a lot of difficulty. It is State and local governments that have the most to gain or lose from coming to grips with this issue. But collectively, they have experienced a great deal of difficulty in actually coming to grips with it because it does polarize people in difficult times. However, that doesn't mean we cannot address the problem in a good way.

We tried our best in S. 700 to determine how the representative tax system would work. But, you are right in raising questions about the discretion given the Secretary of the Treasury, and so forth. Frankly, you have been around here long enough to know it is impossible for people like us to lay out, in detail, exactly what ought to be done with the system. So, if, as we go along, that part of the legislation can be improved and we can better allay the fears of the Texan or the Montanan who'll feel that the Congress is into their pockets to bail out New York and Detroit or Minnesota—if we can better assure them it's going to be a fair system—I think it would be helpful to us.

I want to conclude; there are many other questions that I would like to ask you, but there's one important one related to your comments about the "bird in the hand" theory that we see so much, and this is not a critical statement about Governors, because I am very sympathetic to their problems.

The last time I saw you sitting at a table was over in Environment and Public Works, and there we were discussing infrastructure. Sometime in the next week or so, we are going to busy ourselves with an infrastructure project that will probably look very much like an emergency jobs program, a bunch of pork coming out of Washington in some fashion. To take some of the pork off it, we have the help of people like Governor Kean of New Jersey and others, making it look a little more tolerable. But, most probably we are only expanding another major subsidy in a very inefficient way. Whether it will be the 65-cent subsidy that we get with the tax-exempt bonds, or the 85 cents for categorical grants, we are going to come out of this without a new fiscal subsidy even close to the 99 cents on the dollar we get from revenue sharing.

You testified on this infrastructure problem; it is a real problem for States and they have an important role in helping cities involved in that problem, and to put it as bluntly as possible, if you had $6 billion to send back to the States this year, would you send it out to create some kind of infrastructure banks to float federally subsidized bonds, or would you send it out in the form of State general revenue sharing?

Mr. NATHAN. First of all, on the representative tax system, my own view is that in thinking about tradeoffs, if you really could get omnibus legislation, that putting in a targeted component is easier than changing the basic program.

I would be inclined in trading off ideas—if it ever comes to that, and I hope it will—to go for the targeted component, which can do a lot of what the representative tax system would do, and make your trade that way. I think it would work.

On the point about infrastructure, at that hearing you were at, and at which I testified, we talked about a New Federalism way to support infrastructure development. We ought to find some way to use Federal aid on a basis that would give some assurance to State governments, like grants for water and sewer projects, and mass transit money, on a long-term, 10-, 20-year basis at current levels, plus 3 percent a year or something like that. The Secretary of Treasury could then be empowered to approve State bond banks that would use their flow of funds to enable more construction to go forward sooner than can currently happen.

The key to Governor Kean's proposal is having the Federal Government facilitate State leadership. You need two things: State leadership and State leverage. We shouldn't put $6 billion into infrastructure without thinking very hard about the instruments for doing this and the possible critical role of State governments in many States in planning and in allocating resources and in encouraging better-off jurisdictions to take full advantage of their credit worthiness.

I think that Governor Kean has put his finger on the right way to think about this.

Thank you, Senator.

Senator DURENBERGER. Thank you, very much.

[Mr. Nathan's prepared statement follows:]

PREPARED STATEMENT OF RICHARD P. NATHAN

This is the third time the revenue sharing program has come up for extension. The program began in 1972; since then $70 billion has been distributed—$300 per capita. In my view the program has been a success. Nevertheless, the value of revenue sharing payments has been greatly eroded in the decade since its enactment—a 1972 revenue sharing dollar has eroded due to inflation and the elimination of the states from the program to the point where its purchasing power now is 46 cents.

I have been a revenue sharing habitué, both in government and out, since the mid sixties, and have testtified on the original legislation and both of the previous extensions. In my testimony today, I deal first with S.700 introduced by Senator Durenberger and the overall 1983 setting for revenue sharing legislation; the second section of my testimony briefly considers the history of the revenue sharing program.

THE RENEWAL OF REVENUE SHARING

Two of the central characteristics and great strengths of American federalism are its dynamism and diversity. American federalism is constantly changing; the greatest surprise that could occur under a new administration in Washington would be stability. We live with change as a steady state.

The Reagan administration, in my opinion, has achieved its greatest success in precisely this area—domestic policy and federalism. It has achieved success on four fronts: (1) by advancing retrenchment policies in the domestic area; (2) by changing the tone and mood of domestic policymaking in Washington; (3) by fundamentally revising the nation's welfare policies; and (4) by devolving categorical grant-in-aid programs to the states under block grants. The intergovernmental industry, which grew and prospered in the sixties and seventies, is in a state of shock.

It is in this setting that you are considering the reauthorization of the general revenue sharing program. It is a gloomy time in Washington for state and local officials compared to past occasions on which revenue sharing has come up for renewal.

Under these conditions, it is gratifying that Senator Durenberger has presented a creative proposal for the extension of revenue sharing—a proposal that looks to the future. S.700 contains important provisions that draw in an effective way on the extensive research that has been done on the revenue sharing program.

PROPOSAL: A ONE-YEAR EXTENSION

I have a proposal for this Committee: I suggest that revenue sharing be reauthorized for one year in 1983, and that a study panel be created to report in six months on the elements of S. 700, and other ideas, that require further and longer discussion and analysis before they could be adopted.

Next year is likely to be a better year for federalism legislation—both politically and economically. It could hardly be as grim and inopportune as 1983. If the economy is stronger, it will be easier to make the case for the kinds of proposals in the Durenberger bill that require additional revenue. If the economy fools the experts again and is sluggish next year, that would provide an opportunity to use revenue sharing legislation as a vehicle for targeted and countercyclical stimulus measures.

Such a simple one-year extension would permit careful testing of the formula ideas in S. 700, plus others. This is essential in a governmental system as diverse and complex as American federalism. It also would permit some sophisticated political probing to see if there is an opportunity to enact the two most radical features of S. 700—the trust fund to earmark federal income taxes for revenue sharing and the state-local tax deductibility proposal.

A one-year extension would also allow the time to develop the necessary head of steam for putting the states back into the revenue sharing program. I believe that the argument is much stronger now for doing this. The states, as the critical middlemen of American federalism, deserve to be given a larger role in American federalism in this period of retrenchment by the national government.

A one-year extension would also facilitate consideration of such features as:

1. A targeted fiscal assistance supplement that recognizes the special needs of highly distressed communities;
2. An automatically triggered jobs and public works stimulus component; and
3. The merging of existing block and categorical grant programs into an Omnibus Federalism Act that could reflect some of the ideas in the administration's 1983 version of its New Federalism.

I realize that this proposal for a one-year extension goes against the considerable effort made to win support for a three-year or five-year extension. Nevertheless, I think there are strong reasons for such a strategy, and I wanted to use this opportunity to put some of them before you.

ISSUES FOR A LONGER EXTENSION

If I am not persuasive and 1983 turns out to be the year for a three- or five-year extension of general revenue sharing, then the question I should address is: What are the provisions of S. 700 and other new ideas that are desirable and could realistically be adopted in the current setting?

My answer would be:

1. That detiering is definitely desirable;
2. That the same applies to the spreading out of the maximum and minimum constraints; and
3. That an allocation of additional funds is needed to pay for a "hold-harmless" guarantee as these new formula features are introduced.

I am less certain that in the short run the Congress should adopt the two-factor interstate allocation system contained in S. 700, which uses the ACIR representative tax system concept as one factor. It is not altogether clear how or how well this idea would work in practice; the Secretary of the Treasury is assigned a high level of discretion under this provision, which makes me uneasy. I do agree strongly, however, with the intent of S. 700 in this regard, to "ease fiscal disparities among the states." This subject—the interstate allocation of revenue sharing funds—is an area in which the idea of a one-year extension, combined with a six-month special panel study, makes a lot of sense.

HISTORY OF REVENUE SHARING

Mr. Chairman, I feel compelled, due to my advanced age in revenue sharing light years, to include a brief historical section in this testimony.

Revenue sharing was originally enacted as an instrument of policy and administrative decentralization. It was a Republican initiative, with Democratic support, primarily designed to reduce the role and influence of centralized bureaucracies and, in turn, increase the responsibilities and role of the generalist officials of general-purpose units of state and local government.

In my view, a major effect of revenue sharing was to cause the continuation of the growth in federal aid to states and localities that began in earnest in the mid sixties. In effect, revenue sharing, and the block grants that went along with it, introduced balance and caused growth and stability in the federal aid system in the 1970s.

Now we are in a retrenchment phase of national policy that actually began under President Carter in the late seventies. The Princeton Urban and Regional Research Center is conducting a field network evaluation study of federal aid retrenchment in fifty-four states and localities with financial support from the Ford Foundation and the Commonwealth Fund. We are studying fourteen state governments and forty local governments. A first book has been published on this research; a second is underway.

For the purposes of this hearing, it is clear that a decision not to continue at least the current revenue sharing program would be a fiscal last straw for local governments. Many localities have been hit hard by the recession, federal aid cuts, and tax and spending limits. As the most flexible form of federal aid to localities, revenue sharing is a vital source of funds. It is the most stable manifestation of the compact between Washington and local governments. Its removal would have grave fiscal and federalism consequences.

Senator DURENBERGER. Our second witness this morning is Dr. Edward M. Gramlich, professor of economics and public policy at the University of Michigan.

Dr. Gramlich, you have done extensive and empirical research on the behavior of State and local governments, and I am glad to have you with us today.

You may proceed with your statement in any way you would like. I will have a few questions when you get through.

TESTIMONY OF EDWARD M. GRAMLICH, PROFESSOR OF ECONOMICS AND PUBLIC POLICY, UNIVERSITY OF MICHIGAN

Mr. GRAMLICH. Thank you very much, Senator.

Professor Nathan said many things that I was going to say in my statement. As long as my statement is available, I think I will summarize it very quickly.

Senator DURENBERGER. Your full statement will be made a part of the record.

Mr. GRAMLICH. Right.

I also will summarize quickly and take out some of the things that I had written down, but I do want to add some things that were occasioned by your questions of the previous witness.

I was asked to take a somewhat different perspective on fiscal relations and to talk, not so much about the particular proposals such as yours, but generally about what the system is, how the system can be characterized now, and what the major problems are with it. I think it can be broadly characterized by the four main types of final interactions between the Federal and State and local governments: The first one would be categorical matching grants for particular types of State and local purchases; the second would be matching grants for income redistribution programs; the third would be general revenue type sharing assistance, and the fourth would be the Federal income tax deduction for State and local taxes.

Now, I have two quick points to make about the first two of those, and I will just make them and be done with it, not read the statement.

On the categorical grants, I think that most people agree that from time to time categorical grants are an important part of the fiscal federalism system. I think everybody also agrees, however, that the growth in the categorical grants system got totally out of hand in the 1960's and 1970's. We had far too much categorical grants, and this generated an enormous bureaucracy, enormous confusion, enormous paperwork, and lots of things that nobody likes, and the system just had to be reined in.

There are basically two ways to rein it in. One that has been a favorite of every administration for the past four or five, the ACIR, and other groups; one that has not been much talked about. The one that has been the favorite has been the block grants system, where groups of categorical grants are combined together, packaged into a block grant, the strings taken off, and the money is, in effect, given to State and local governments as sort of a hybrid form of revenue sharing. That is fine. I have nothing against it. If some of the categorical grants that get combined are serving valuable purposes—and frankly we do not really know whether they are or not—there are certain dangers in that approach, but I think everybody recognizes that.

There is another approach to reining in the categorical grant system that I think it might be worth talking about, as long as some of these basic issues are being raised. That is that the typical categorical grant has the Federal Government pay about 80 percent of the cost of a particular program. What that does is that it encourages States to go after these grants willy-nilly and encourages them not to manage them very well, because it is, for the most part, somebody else's money.

As long as prices and markets are in vogue these days, another approach to this problem might be just to start lowering the Federal matching shares and encouraging States to manage programs better through this pricing mechanism. I am not going to say that this grant, the matching share ought to go for B to 62, because my knowledge about that is not that precise, but I think it is certainly an approach that bears further consideration.

The second item is matching grants for income distribution, and those were much in the news 1 year ago in response to President Reagan's proposal for essentially eliminating all of them and turning all redistribution responsibilities, except for medicaid, back to State governments. I was, at the time, very critical of that particular initiative. Although I still am, I would be glad to elaborate on it if you care.

But since that is not the main business this morning, I will pass over that section of my statement, which is available in print.

The third feature is the general revenue sharing, and there, I will not read what I have down either, because it is substantially in agreement both with the things that are implicit in your proposal and also what Professor Nathan was saying a minute ago. I am like others in viewing the main advantage of general revenue sharing type assistance as one that provides a very powerful and effective incentive toward fiscal equalization. I interpret your proposal, S. 700, as a strong step in that direction. I am not expert in all of these formulas on what you put in or what you take out, although I think that perhaps Professor Nathan is right; that it might be well to have a panel examine some of those issues in close detail.

But I certainly would commend the broad thrust of the proposal. I think that is moving general revenue sharing exactly in the right direction. I think also that even though it is an arrangement that sometimes sounds a little corny to economists, but I would also think it would be important to get the States back into the overall program on the grounds that the fiscal federalism really is a set of fiscal partnerships and that we can certainly encourage closer final cooperation between States and their localities if they are part of the same program.

So I do think there is some advantage in those directions.

Now, the inventive feature of your proposal is where you get the money. Everybody has been for revenue sharing, and it would be nice to have that. We have all agreed on that for some time.

But the question, as you know, has been that we are looking at such enormous Federal budget deficits that general revenue sharing may not be the highest priority use of the $6 billion. That is the exact question that you asked Professor Nathan. Let me answer that by saying that, while I am not sure that $6 billion given in the form of revenue sharing is the highest priority use of the money these days, I do think the package of revenue sharing and eliminating—either partly or fully—the Federal tax deduction for State and local taxes would be a high-priority need.

So I would like to see this revenue sharing, and the fourth item on the list, which is the Federal tax deduction, as part of the package. What I like about your proposal is that you have put them together explicitly as a package.

Let me read from my statement on this last item on the tax deductibility. The final item is one that I think should not be on the list, that is, the list of instruments that the Federal Government has in influencing State and local behavior. The income tax deductibility of State and local taxes would seem to have as its justification the stimulation of State and local consumption of various public services. Except that I think there are much more efficient and equitable ways to stimulate any such consumption that should be stimulated. The tax deduction could be dispensed with without great loss.

The first problem with the tax deduction is that the subsidy is quite uneven across taxpayers. One who does not itemize deductions gets no subsidy at all. One in the 25 percent maximal Federal tax bracket who does itemize gets a 25 percent subsidy. One in the 50 percent bracket gets a 50-percent subsidy, and so forth. This implies a greater dollar subsidy for the rich than the poor.

Moreover, since it is now true that 70 percent of all Federal taxpayers do not itemize deductions, this stimulus may very well have no or little impact at all on the person known as the decisive voter in State and local fiscal elections. Politicians will know this voter as the swing voter, the one whose support is critical in gaining passage of some fiscal choice.

Third, as the deduction now works, there is an incentive for States and localities to use taxes that distort the allocation of resources—income, sales and property taxes—and not to use taxes that do not distort this allocation—user charges—and not to use taxes that are distortionary in what I would consider to be a desirable direction, such as gas taxes.

Finally, if it is true that some subsidies of State and local public spending is in order, those subsidies can be more selectively focused either on types of spending by categorical grants or on areas by general purpose grants.

We have a subsidy that is neither efficient nor equitable and for which there are much better alternatives. Why retain it at all?

That leads me into a final comment on S. 700. That would be that if I can think of one thing that should be induced by that program, my own candidate would be to eliminate the tax deduction not as you have done, which is just the amount below 1 percent of the adjusted gross income of the taxpayer, but I would just eliminate the whole thing.

The State and local lobby will be on your back for this, but I would pose the question as follows: If the whole deduction is eliminated, there is an added $25 billion of Federal revenues. That $25 billion, I need not say, is very much desired in Washington these days. The budget deficits are too large in the future, and politicians and economists of every persuasion agree on that. There has never been so much consensus on an issue in anybody's memory.

The State and local lobbying will be upset about eliminating the entire deduction, but I think there is a way to combine, as a package, eliminating the deduction and adding some more to the general revenue sharing.

You have a trade of $6 billion, elimination of the deduction and $6 billion more general revenue sharing. One could eliminate the whole deduction. That would save about $32 billion, and then maybe you could have revenue sharing of $10 billion instead of $6 billion or something on that order.

The choice for State and local governments, then, becomes, "would you like to have an extra $4 billion of revenue sharing or an extra $26 billion of Federal tax deduction?" My own judgment on the efficiency of that is that State and locals would be better off with the added revenue sharing than they would be with the tax deduction.

That is looking at things solely from the standpoint of the State and locals. I think from the standpoint of the country that this would be a very, very welcome improvement in the Federal tax system.

So I would be strongly in favor of that.

That ends my statement, but I would like to make also a point on this infrastructure program that you mentioned a second ago. I am not sure what that program is, because I have not seen it or heard of it before now.

But let me just caution you on what I consider to be some pitfalls with the general idea of trying to stimulate State and local construction in a recession. It sounds very obvious that we ought to do that. There are a couple of problems, however: The first is, and there is actual evidence on this score, that if you put a tracer on the money that we have used for these purposes in the past, that that money often does not get spent until much, much later; indeed, sometimes more than a decade later.

So it is not a very effective way to target things in a recession.

I did a study of the local public works bill in the mid 1970's, that came along, I believe, in the 1975–76 period, and I am pretty convinced that that bill lowered the State and local construction and lowered it sharply. Why is that?

The reason is that again we had a situation where the Federal Government was paying the entire cost of the item to be constructed. We also had a case where there was substantial uncertainty for any particular State and local government—whether they would get the money or not. I happened to have just moved to Ann Arbor at that time. Ann Arbor was considering building a firehouse. Without that bill, they would have just gone ahead and built the firehouse. When the bill became known, they thought, "wait, we might be able to get the Federal Government to pay for this whole firehouse." So they waited 2 years and did not build a firehouse until they finally got the money 2 years later. There was a big delay in the construction that they would have otherwise done, and the State and local construction dropped sharply at that time—I think because of that bill.

There are some very significant pitfalls in that particular approach. In the question you posed to Professor Nathan, I am for the revenue sharing. I think that it has got local public works beat hands down.

Senator DURENBERGER. Thank you very much. I have got a variety of questions to ask you about the whole infrastructure situation, and lest anybody think I do not appreciate infrastructure concerns, particularly faced by the cities in this country, I think I was one of the first people to start making speeches on that subject going back 2, 3 years ago. My apprehension, though, is fostered by the experience of raising the gas tax just before Christmas and then doing a jobs bill which nobody believed in, except two Irishmen, one of whom happened to be in the White House, and the other, the Speaker of the House, happened to just have come back from China. Out there are a lot of local governments in desperate need, with responsibilities given by the electorate, and they are willing to grab at just about anything.

My deep concern comes also from the experience on another committee with social security. Part of this whole problem is what kind of a debt load or a payroll tax load are we putting on our kids out there in the future. And as we struggle through this particular period of time, I know we are tempted to extend a variety of tax exemptions and other kinds of tax based subsidies to very desperate mayors and county commissioners and others. And I question whether by doing this we are not encouraging them to reach out and do whatever they can to create a job opportunity through mechanisms that are not really very well suited to the task.

Clearly, the focus of Professor Nathan's statement and, by implication, yours, is that as we look to the role of State governments—as Governor Kean is doing in his infrastructure proposal—it is not just a matter of Republicans going to their buddies, the Governors, while Democrats go to their buddies the mayors. There is something different going on here in that the States, as States, have a different role to play in the federal system and the futures of their people. That's one of the things I am sure you were pointing out in talking about our national responsibility for income security.

We are just starting to see the States use their leverage on a variety of delivery systems out there. Certainly, part of the solution to the infrastructure problem is user fees. But it is very difficult to put those fees into effect right now, and they are not going to get there until people say, "I have got to have the service and I am willing, in some way, to pay for it."

I just offer that by way of our shared concern about moving too quickly with simple solutions on infrastructure.

I want to get back to revenue sharing. You made a comment that everybody is for revenue sharing; that what is different about S. 700 is the way that we finance it. The fact of the matter is, everybody is not for revenue sharing. We do have a $200 billion deficit, so every $4.6 or $5.9 or $11 billion or whatever, has to come from somewhere.

One of the notions that I have used to justify this expanded form of State revenue sharing is that it ought to be used to mitigate fiscal disparities—not equalize them, because I think to some degree fiscal disparities are fine, in that they promote healthy competition and so forth. Diversity is one of this Nation's greatest strengths. But to mitigate fiscal disparity, in your view, is that an appropriate use for State revenue sharing?

Mr. GRAMLICH. Absolutely; there is a very simple answer to that.

Senator DURENBERGER. OK. How about the argument that the folks who have the privilege of spending the money should also have the experience or the pain of levying the taxes to raise it? How do we answer the accountability argument with regard to revenue sharing?

Mr. GRAMLICH. I think that that is an argument that I take seriously, and when Professor Nathan talks about revenue sharing, it sometimes gets very mystical. I am not quite sure that I see the same higher significance to it up there.

I think that is a question that I feel that I do not have any very final answer to. I think it is possible to defend revenue sharing on more technical grounds, and that is how I prefer to defend it. One of those is that certainly, at the margin, raising revenue through the Federal tax system is no worse than raising revenue through the State and local tax system.

The second argument that I would make is that, just as you put it a minute ago, there is more potential for evening fiscal disparities with the revenue-sharing approach.

The third argument, which I think is perhaps not true in all kinds of proposals but is true in your particular proposal, is that I think it makes very good sense to view revenue sharing or added money to revenue sharing as some compensation for State and local governments for getting rid of the income tax deductibility. It is certainly appropriate, and in a very long tradition in public finance economics, to make a change like that, coupled with something that holds harmless State and local governments. So I see the added revenue sharing that you have got as part of a very sensible package that, taken together, makes good sense.

Senator **Durenberger**. Let me turn to the tax deduction as a subsidy to the State and local governments. I have a very competent staff back here that reads all the studies, and they tell me that looking at how the Federal tax deduction impacts on the fiscal behavior of State and local governments, it is worth about a dime on a dollar in terms of State and local tax room. You have heard that figure.

You made some reference to the decisive voter or the swing voter, or whatever; there are a bunch of them in Minnesota, let me tell you. [Laughter.]

Governor Snelling will be here this afternoon, and I am not sure exactly what he is going to say, but when we had breakfast on this subject, he took himself out of his Governor's chair and he sat down as a taxpayer. And he said, "As soon as the Federal Government says it is removing some of the deductibility, that sends a signal to the taxpayers that it is not worthwhile paying State and local taxes."

I just wonder whether that signal appears every time the State legislatures debate whether or not to raise the sales tax or the income tax or, indirectly, by not raising the income tax or the sales tax, to raise local property taxes. What actually happens out there?

Mr. **Gramlich**. I think there is something that is kind of neat about all of that, but that means that there might be some margin for doing what you want to do without making them worse off. What that is is that it is true, on average, that 70 percent of the voters in the Governors' jurisdiction will not experience higher taxes as a result of removing the tax deductibility; 70 percent of those voters do not itemize.

Now, I will be the first to admit that we need to study that more carefully. I know that 70 percent of the Federal tax returns do not claim itemized deductions; that only 30 percent do.

I do not know what the voting rates are for those that do and do not and so forth. So this statistic should be computed more carefully. But if it is true, then the swing voter, on some of these choices, may not feel strongly affected one way or the other by that itemization. This is quite different from charitable contributions. A charitable contribution, if the person that gives money to the University of Minnesota loses that tax deduction, then that person reduces the contribuion. It may not be that the same person would reduce their State and local tax payments, the level of which would be determined jointly by people, most of whom do not lose from eliminating the deduction because they do not itemize.

Senator **Durenberger.** Nobody sits around between Christmas and New Year's figuring out how much more State and local taxes they might pay to reduce their Federal tax liability then, right? Is that the difference?

Mr. **Gramlich.** Not quite. The swing voter, if he does sit around like that, realizes that the deduction doesn't matter.

But we could make a further point. As is implicit in your proposal, there could be compensation to local governments, and so they could get back their dime on the dollar or whatever this was appraised to be worth.

Senator **Durenberger.** Let me build on this, then.

We are only 10 days away from income tax payment time. Let's suppose these folks who sit at these press tables, who I assume are good communicators—they must be good because they are not asleep as is often the case at these hearings—suppose somehow or another one of them decides to just go out there and say, "The Congress or at least the Senate or at least this crazy Senator from Minnesota is going to get rid of State and local tax deductibility on your Federal income tax."

If everybody had the experience of just totaling up their sales tax and their property tax and decided to stick it to Senator Durenberger and whoever, they could blow this out of the water, right?

Mr. **Gramlich.** They could, but somehow. Senator, somebody in Washington is going to have to raise taxes. You know it, I know it, and those folks know it, too.

I guess my only argument is, how are we going to raise them? I would like to raise them in a way that makes the most economic sense. I think it makes more sense to raise them this way.

Senator **Durenberger.** I have tried to make that same argument to the Governors and legislators and other people. I have also pointed out that this linkage that I have made between revenue sharing and limiting deductibility is not all that unique.

I have another linkage in which we put a cap on the tax-free nature of health insurance premiums. Now we can use the proceeds in recovered Federal taxes to buy health insurance for United Auto Workers when they are unemployed, rather than using taxpayers' money to pay auto workers $312 a month to buy health insurance they don't want or need.

Why do I suggest these linkages? Am I against health insurance and property tax deductions? No, but I know that those deductions are both inefficient and ineffective in achieving the objective we originally set for them, and as Congress begins to realize this they are going anyway.

Last year we sat around a table like this, down one floor, and we decreased the medical deduction, and the casualty deduction, for example. We are just starting to get rid of these things.

That 70-percent figure for nonitemizing taxpayers is growing all the time, and those folks want some kind of a flat-rate tax. They don't want all these exemptions, except for the few of them up near the top who are trying to get down from 50 percent to some lower marginal bracket.

So I understand their view, and I am trying to understand the political problems. I don't know whether the taxpayers will be on my back. I know that when my Governor, Rudy Perpich, and the Democrats in the Minnesota Legislature a couple of weeks ago proposed to eliminate Federal income tax deductibility, my impulse was to say, "Oh, no, no, no. Don't you do that." I took off my Senator hat, and I put on my $100,000-a-year hat and said, "Not only is Minnesota already the highest income taxed State in the country, but you want to make us twice as high as everybody else."

So we all, in one way or another, seem to have problems with this whole deductibility thing, and, yet, you seem to be implying that it isn't as big a problem as some of us think.

Mr. **Gramlich**. I am not going to advise you on politics. You are a professional in that, and I am not. I am just talking about what made sense to me, one lonely economist, as I look at both the revenue-sharing system and the tax system.

Having said that I am not going to make political statements, let me now make one. That is, that I think a reasonable prediction of what is going to happen to the Federal tax system is more bills like TEFRA.

Last year there were a number of deductions, and so forth, that were eliminated, and people said no way would they ever be eliminated, but the pressure of the Federal deficits were so enormous that they were eliminated.

It may be that State and local governors lose this tax deduction some day in a meeting one floor below us with no dollars at all to show for it.

I think that it could make sense for them to get behind your proposal; at least they get some money for it. This political thing is elusive.

Senator **Durenberger**. I just have a suspicion that could be this year. Everybody says no, but when I see the House coming at us with a $30-plus-billion tax increase, and they do it in ways the Senate probably cannot support, like eliminating indexing and eliminating the third year of the tax cut, and so forth, we have no choice but to come back and play tough, too.

One of the alternatives being offered up is eliminating deductibility of State sales taxes. But then we are in the business of saying we don't like sales taxes, but we do like income taxes.

Mr. **Gramlich**. That is right, and once you get into that, as your own staff document points out, if you are going to do it for one tax, then you really do generate a lot of new inequities and new inefficiencies in not doing it for all taxes.

Your staff document was very persuasive on that point.

Senator **Durenberger**. Let me finish this up with saying you and I, at least, seem to be on the same track, looking at this new general revenue sharing as a foundation for a New Federalism package. And as I recall your written statement, you make a strong statement that I certainly agree with; that the Federal Government has a responsibility to guarantee to all individuals in this country some adequate level of income security.

Our problem is finding out exactly how to make that guarantee and at the same time give flexibility to the people at the State and local government level to suit those programs to their own unique needs.

Are we in basic agreement there?

Mr. **Gramlich.** Yes.

On income support, I did not get into that in my oral remarks, but I would be for basic Federal support and then allow State supplements as States want to, but make States pay the full cost; that is, there should be something like maybe an expanded food stamp program or something, and then allow supplementation over and above that level.

That, I think, would be the way to reform welfare.

That is a whole different can of worms, though, as you know.

Senator **Durenberger.** Right. Let's say we could solve the income security problem. We go down and start this year to solve the medicaid problem, which is probably the fastest growing problem in that whole system; and if you can solve that one, maybe you can solve food stamps and housing and maybe a few other ones. Assuming that somehow we can solve the income security question, it seems to me that the variability in public service expenditure needs among the States is very substantially reduced.

Would you agree with that?

Mr. **Gramlich.** Yes.

Senator **Durenberger.** That the idea that we have to "needs-test" a lot of these non-welfare-related programs sort of starts sliding out the window once we come to grips with income security?

Mr. **Gramlich.** It is not, as you know, totally eliminated. To represent my great State of Michigan, I will still have to worry about Detroit, for example. The needs of Detroit will not go away as you have adequate income distribution.

But the needs of Detroit will be significantly less than they are now; there is no question about it.

Senator **Durenberger.** OK. But that gets us, then, into the next part of the problem, which is the whole issue of fiscal disparity.

If we design a categorical program of some kind, whether it is an infrastructure program or whatever, say to do mass transit, you know as well as I do that Houston is going to be in here to get the same pot of gold that Detroit gets.

Is that justified, in your opinion?

Mr. **Gramlich.** I guess what I would say about that is that there ought to be, basically, two kinds of grants: One type is categorical for particular public goods such as mass transit, or interstate highways, or maybe even now toxic waste disposals. The second is revenue sharing type of grant that I would make more strongly targeted toward areas of low incomes or lower fiscal capacity.

So, no, it would not bother me, if we had an adequate targeted revenue sharing in place if Detroit and Houston paid the same share of mass transit expenses.

Senator **Durenberger.** OK, but you qualified that by saying if we had an adequately targeted revenue-sharing program.

Mr. **Gramlich.** Right. Then if you don't, you might want to mix them in some way.

Senator **Durenberger.** But Michigan can probably do a better job of helping Detroit priortize its needs, whether they are human needs or infrastructure, than people sitting around this table who have to design each of those programs so they fall identically on the Houstons and the Detroits and the Phoenixes and the Minneapolis-St. Pauls.

So there is some value, if we can pull the income security part out of this problem, in leaving the determination of the rest of the needs to a substantial degree to States, if we have done something about the fiscal disparity issue.

Would you agree to that?

Mr. **Gramlich.** Yes. Absolutely.

Senator **Durenberger.** All right. I think, unless you have something else that you want to add, that I can express my appreciation to you for being here and the time and effort that you have put into preparing.

If you have any more thoughts on the subject, I am sure we will be around dealing with the issue for some time.

Thank you.

[The prepared statement of Mr. Gramlich follows:]

Testimony before the Senate Committee on Governmental Affairs Subcommittee on Intergovernmental Relations April 5, 1983

Edward M. Gramlich
Professor of Economics and Public Policy
The University of Michigan

Thank you for inviting me to testify today. In my remarks, I will briefly recount what I consider to be the major problems with the United States fiscal federal system right now, and recommend some changes. I will also comment briefly on the Durenberger proposal for revising and expanding the general revenue sharing program -- as it happens, that makes a number of the reforms I favor. I feel it is also a much more constructive solution to most of these problems than the set of proposals unveiled by the President last year.

The Main Problems with the Present System

Before we start criticizing the present system of intergovernmental fiscal relations, we had better understand what that is. For present purposes I consider it to consist of four major items:

1) categorical matching grants for particular types of state-local purchases;
2) matching grants for income redistribution programs;
3) general revenue sharing, or unconditional, grants;
4) the federal income tax deduction for state-local taxes.

The promise of the system is that this set of instruments is broad and diverse enough that it is possible to design fiscal incentives to accomplish many different objectives. The difficulty is that if the incentives are not designed correctly, some unintended or adverse consequences can result. Our present system has much promise, and many problems.

The first item, now accounting for about forty percent of the aggregate federal payment to state and local governments has been the focus of much criticism for the past decade. Special purpose categorical grants sprouted up like wildflowers in the sixties and seventies, and by last year there were over five hundred such programs, many very small. Each program had an extensive set of rules, regulations, application procedures, and the like, with the result that the cumulation of all such programs created a large and inefficient grants bureaucracy. Another problem was that the federal matching share was so high for the typical program -- eighty percent on average -- that there was little incentive for states to manage the programs efficiently, or even to decline the funds.

One can imagine several ways to rein in such a system. The preferred procedure for economists would be to encourage more local efficiency by lowering federal matching shares. The preferred procedure for most politicians -- starting with the Nixon administration, continuing through the Ford, Carter, and Reagan administrations, and also including the ACIR -- was grant consolidation. Particular categorical grants were bundled into block grant packages and converted to more or less unconditional grants. This process has gone quite far -- by now about $15 billion worth of categorical grants has been "blocked". What little evidence there is suggests that any impacts of consolidation of state-local spending have been quite minor, perhaps because states were already quite ingenious at circumventing the categorical restrictions and using the grants for their own purposes.

Hence at a minimum, consolidation appears to be worthwhile as an administrative economy, and perhaps more should be done. But it would be nice, as long as Congress is in a budget cutting mood, for it also to consider lowering federal shares and letting the states pay for more of their expenditures.

The second item has been much in the news in the past year, since President Reagan proposed to halt all such redistributive grants and return those responsibilities to state governments. There are many problems with such a devolution, the most basic being the fear of migration in a federal system. Were states to have sole financial responsibility for income redistribution, even those state desiring to be generous might find that generosity rewarded by attracting new transfer recipients from other less generous states, or they might perceive such a result to be the ultimate outcome of their generosity. The clear incentive, then, is for states not to be very generous, which in turn means that devolution of income redistribution responsibilities is not a very good idea. This time the political instinct of state governors in resisting the transfer of responsibilities has accorded well with what I think most economists would have felt about the matter.

The third item has not received as much publicity, but perhaps it should get some attention. As a result of the recession, high state and local bond rates, and various grant cutbacks, state-local treasuries are in terrible shape right now. Some increase in federal fiscal assistance to state-local governments might make sense even for this reason -- though that is a hard argument to push because there is certainly not a major difference between whether the federal or a state government raises taxes at the margin. But there is a stronger argument for increased general purpose assistance -- since there is a great variance in fiscal capacity across states and localities (fiscal capacity is essentially state or local income adjusted for the jurisdiction's ability to garner tax revenue from nonincome sources), it would further make sense to "target" this general purpose aid to poorer areas much more emphatically than general revenue sharing now does. In such a way, the financial ability of areas with differing incomes and wealth to consume public services such as health and education could be made much more equal.

The final item is one that I think should not be on the list. The income tax deductibility of state and local taxes would seem to have as its justification the stimulation of state and local consumption of various public services. Except that I think there are much more efficient and equitable ways to stimulate any such consumption that should be stimulated. The tax deduction could be dispensed with with little loss.

The first problem with the tax deduction is that the subsidy is quite uneven across taxpayers. One who does not itemize deductions gets no subsidy at all. One in the twenty-five percent marginal federal tax bracket who does itemize gets a twenty-five percent subsidy, one in the fifty percent bracket gets a fifty percent subsidy, and so forth. This implies a greater dollar subsidy for the rich than the poor. Moreover, since it is now true that seventy percent of all federal taxpayers do NOT itemize deductions, the stimulus may very well have no impact at all on the person known as the "decisive" voter in state-local fiscal elections (politicians would know this voter as the "swing" voter, the one whose support is critical in gaining passage of some fiscal choice).

Thirdly, as the deduction now works, there is an incentive for states and localities to use taxes that do distort the allocation of resources (income, sales, and property taxes), and not to use taxes that do not distort this allocation (user charges) or taxes that are distortionary in a desirable direction (gas taxes). Finally, if it is true that some subsidy of state or local public spending is in order, those subsidies can be more selectively focused on types of spending by categorical grants, or on areas by general purpose grants. We have a subsidy that is neither efficient nor equitable, and for which there are much better alternatives. Why retain it?

The Durenberger Proposal

I was asked to comment mainly on the general shape of federal-state fiscal relations, and not on any particular proposal. However, since the subcommittee is now considering a proposal that makes many of the reforms I am proposing, I would like to spend a minute discussing it.

Basically, the proposal is to revise and expand general revenue sharing, in a direction I suggested in my discussion of item 3) above, and to limit the federal income tax deduction of state-local taxes, in a way I suggested in my discussion of item 4) above. The advantages of both changes have already been explained. The revenue sharing money is very timely, given the fiscal troubles now being experienced by many communities, and in being focused more on poorer areas than is the present general revenue sharing program by the use of fiscal capacity in the formula, it should make a desirable, if small, improvement in the region-wide distribution of income.

Limiting the tax deduction is also very timely. The practice of creating new tax loopholes has gone beyond all reason in recent years, and the nation badly needs a few measures that broaden, not narrow, the tax base. Limiting the income tax deduction for state-local taxes is certainly one of them. The way the proposal limits tax deductions, by allowing only those exceeding one percent of adjusted gross income, insures that any revenue consequences for state-local governments will be minimal. In the first place, as I said above, most taxpayers now do not itemize deductions, so their willingness to vote for state-local expenditure programs should not be affected at all. Secondly, even if they do itemize, most will still benefit from the deduction at the margin. The Durenberger proposal is an ingenious way to raise federal tax revenues WITHOUT having much affect on state-local tax revenues.

I am sure that even in proposing this small limitation, compensated by a simultaneous increase in general revenue sharing funds, Congress will be subjected to vicious pressure by the state and local lobby. That pressure may make Congress unwilling to consider further changes. However, as long as some pressure for tax reform is also in the air, let me suggest that you consider revising and broadening the Durenberger proposal to ELIMINATE the income tax deduction for state-local taxes altogether. This will, ~~as you know,~~ provide another $25 billion in federal revenues, some of which might be devoted to general revenue sharing or other grant programs, but most of which should be devoted to reducing the very damaging long term budget deficits now being forecast. I remain convinced that the impact of even this large change on state-local revenues will be minor, but the efficiency, equity, and even macroeconomic advantages will be quite major.

Senator **Durenberger**. Our final witness this morning is Arthur R. Goldbeck, an Associate Director of the General Accounting Office.

I understand he is to be accompanied by Jerry Fastrup.

Arthur, you may proceed.

TESTIMONY OF ARTHUR R. GOLDBECK, ASSOCIATE DIRECTOR, GENERAL GOVERNMENT DIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY JERRY FASTRUP, GAO EVALUATOR

Mr. **Goldbeck**. Mr. Chairman, we have a longer statement, but I would prefer to summarize it.

Senator **Durenberger**. All right. Your full statement will be made a part of the record.

Mr. **Goldbeck**. Thank you.

We are pleased to appear today to comment on proposed formula changes contained in S. 700, which revises and extends the general revenue sharing program.

GAO has long endorsed the type of changes the bill makes in the allocation of funds to local governments. The bill proposes replacing the five factor and three factor interstate formulas with a two factor formula, based on population and tax capacity as measured by the representative tax system, generally referred to as the RTS.

We believe this change will improve the targeting of revenue sharing funds among States. The new formula would no longer use tax effort as one factor in allocating revenue sharing to States.

Tax effort was originally included in the interstate formulas to reward those States which made strong efforts to raise revenue to provide needed services to their citizens.

Our current work on the allocation formulas concludes that to neutralize fiscal disparities, Federal funds should be allocated on the basis of a fiscal capacity gap that measures States' revenue raising potential relative to a national standard.

The new mathematical structure used in S. 700 measures such a revenue gap.

We believe it would improve the equitable targeting of revenue sharing funds.

The use of the RTS as the measure of a State's taxing capacity would improve the equitable distribution. Our recent report on the medicaid matching formula concluded that the RTS is conceptually better as a measure of tax capacity than personal income because the RTS attempts to account for all the major revenue sources typically used to finance State and local public services.

The use of personal income in the present formula assumes that all revenue sources are highly correlated with income.

Research shows, however, that this just is not the case.

I would next like to turn my attention to the changes in the formula used to allocate funds to local governments. The local three-factor formula is designed to increase aid to more needy local governments, that is, those with large populations, low per capita incomes and high levels of tax effort.

While elimination of the tax effort factor may be appropriate at the interstate level, we believe it should be retained in the local formula because at the local level it serves as a measure of the service responsibilities of local governments.

Unlike the situation at the State level, there are large differences in service responsibilities of local governments that the tax effort reflects.

The tax effort factor, therefore, plays an important role in targeting funds to those local governments with greater need and should therefore be retained. While a more accurate measure of tax capacity for local governments would be desirable and, we believe, possible, we believe collecting the data necessary to develop a local representative tax system for all eligible local governments would be prohibitively expensive.

Because the local three-factor formula is fundamentally sound, equity would be served if the formula were allowed to operate with a minimum of limitations because local governments with equal need would receive equal revenue sharing payments.

The first change we would like to discuss is detiering.

With tiering in the current fomula, funds are first allocated to county geographic areas; divided into separate allocations for the various types of governments in the county, such as cities and townships, and then allocated to individual jurisdictions.

Most of the funding inequities we identify can be corrected by eliminating the tiering procedure and allowing all local governments within a State to compete for funds from a single State allocation on the basis of their individual characteristics of population, income, and tax effort.

We estimate that this detiering would shift about 3 percent of total program funds and would significantly improve funding equity for many local governments.

A second equity issue concerns the minimum and maximum per capita allocation provisions. Provisions in S. 700 would lower the 20-percent minimum to 15 percent of the State per capita amount.

While lowering the minimum 15 percent would improve the allocation of funds, we believe consideration should be given to lowering it even further or perhaps eliminating it entirely.

Revenue sharing allocations are also subject to a maximum per capita amount equal to 145 percent of the State per capita amount. Past research has shown that this cap severely limits the allocation of funds to some of the Nation's fiscally distressed cities such as New York, Philadelphia, Baltimore, and St. Louis.

We support raising the 145 percent cap to 175 percent.

The last formula issue I would like to discuss today is the inclusion of user fees into the local formula. Because the current formula does not consider user charges, it does not respond to the shift in revenue sources utilized by local governments to finance government services.

If user charges and taxes were both considered as proposed in S. 700, the formula would better measure the revenue raising efforts localities undertake to provide public services.

Mr. Chairman, I would like to mention one other issue that is not related to revenue sharing formulas. The current act requires that governments receiving $25,000 in revenue sharing have an independent audit of their financial statements at least once every 3 years.

We have long recognized the value of such audits in increasing citizens' confidence in their governments and in assuring financial integrity and that government funds are properly spent, accounted for, and reported to the public.

We would suggest that this audit be conducted annually to better achieve these objectives.

Mr. Chairman, that concludes my formal statement. We would be happy to answer any questions you might have.

Senator **Durenberger**. Thank you, very much.

As I said in my opening statement, the revenue sharing program that I have outlined in S. 700 is not simply built on the notion that we ought to put the States back into the old revenue sharing program. It is built as a foundation for a New Federalism. Its aim is to find an expandable and efficient way to return financial resources to all of the States so that they will undertake the responsibilities that New Federalism would place on them.

But at the same time, we have to make sure that the poorest of the States have a promise that if they exert at least some reasonable tax effort under this New Federalism, they are going to be able to provide an adequate level of service. So to those ends, we make two major changes in the interstate formula: we remove tax effort and replace personal income with the representative tax system.

I wonder, since you hit on that issue in the first part of your statement, if you would elaborate on why, given those stated objectives, you feel these changes in the interstate formula are important changes.

Mr. **Goldbeck**. We believe the way the formula currently works, some States have a tremendous advantage over others in raising taxes. For example, those with large energy resources are able to tax those resources as they are used and exported to other States and other countries and, therefore, have a much larger capacity for raising funds to help themselves than other less advantaged States.

The changes that you have proposed in S. 700 would tend to equalize the potential revenues that different States would have by establishing and using a representative tax system.

Senator **Durenberger**. How about those who have, in a way, grown up with the notion of tax effort? How would you argue to those people—maybe it is a technical argument—that we ought to remove the tax effort factor?

Isn't this the basic argument: That even if one holds to the premise that public sector spending is a very laudable thing to do and it ought to be rewarded in some fashion by the Federal Government, that inclusion of tax effort in the formula really doesn't achieve the objective of rewarding high efforts without producing some very substantial and adverse side effects in a lot of the States?

Mr. **Goldbeck**. I think what happens currently is that rather than rewarding those States that are making large efforts, we are actually rewarding those that happen to have an advantage because of their resources.

What happens in those States with very high tax efforts in the current formula, they are actually obtaining a lot of those taxes from residents of other States because the current formula compares the taxes they collect with the income of the residents of their State.

So, obviously, if they are able to export those taxes to other States, they are going to be collecting very large amounts of taxes in relation to the income that the residents have and, therefore, we are going to give them more revenue sharing funds under the current formula.

I don't think that that particular occurrence really recognizes the needs of the individual States, and, I think, as you propose in your bill, we would suggest changing that.

Senator DURENBERGER. Maybe some people have a difficult time understanding why we replace tax effort with the representative tax system at the State level but we don't recommend doing that at the local level where we continue to maintain the three-part formula, including tax effort.

Is there a way that, in layman's language, you could help me explain doing that for folks out there?

Mr. GOLDBECK. Basically, at the State level, first of all, you are only dealing with 50 entities and have data you can collect. But probably more importantly than that, all States, generally speaking, provide about the same kinds of services.

When you go down to the local level, comparing the taxes they collect with the kinds of services that are provided you find major differences that don't exist at the State level.

For example, where I come from in Illinois, the school districts were run by the counties. The counties were sort of an average-type of government. Counties in California are much stronger. Counties in New England are very weak and provide very few services compared to the cities and townships.

So you have these differences in the types of responsibilities that local governments have, and depending on what part of the country you are in and what State you are in, different levels or different types of local governments have different responsibilities.

Second, it would be very difficult—because you are talking about 39,000 different types of governments—it would be extremely difficult to be able to come up with what we would call a reasonable representative tax system for local governments.

Senator DURENBERGER. Let me go now to the changes in the local formula. I take it GAO has had an opportunity to study some of what we call the "distributional consequences" of the changes that were proposed. The first time we heard all of this was 1980, as I recall. Is it a fact that GAO has done some analysis of the consequences at the various levels?

Mr. GOLDBECK. Yes, we issued a report since 1980. The report came out last April, April 15, 1982, where we studied the tiering procedure that is currently in the program.

Based on the results of that study, we believe, and I am convinced, that revenue sharing would be much better distributed to local governments if we eliminated the tiering procedure that is currently in the act.

Senator DURENBERGER. Were you able to put any dollar value or some percentage of the total value on the detiering shift?

Mr. FASTRUP. Yes, our analysis showed if you detier the formula, the total amount of the funds shifted is about 3 percent of the $4.6 billion allocation or approximately $200 million. This in itself sounds relatively small, but detiering affects groups of governments and individual governments considerably more.

In the end, the amount of money to hold the losing governments harmless is relatively small, but for a large number of governments there would be a significant improvement in the equitable distribution of revenue sharing funds.

Senator **Durenberger**. Three percent isn't much, doesn't sound like much, particularly compared to the figures we talk about here. Even as $200 million out of $4.6 billion, it doesn't sound like much. But your response would indicate that, in a political sense, I suppose, a good part of that 3 percent is falling on relatively few jurisdictions; it is not evenly spread across the 39,000 or even half of 39,000.

Mr. **Fastrup**. The size of a loss varies from situation to situation, and a real good example is New Jersey.

In Essex County, which contains Newark and its suburbs, there have been city governments who have actually changed their legal classification from city to township in order to increase their revenue sharing grant.

That happens because of the tiering process, and when they move from a city to a township, some of these governments have increased their allocation by as much as 300 percent. Consequently, when you detier the formula, those governments would wind up losing somewhere on the order of 70 percent of their allocation.

So in individual circumstances, the shift could be substantial for some governments. By and large, it is much more moderate, but there are individual situations like Essex County, N.J., where the changes would be substantial.

Mr. **Goldbeck**. Could I add something to that?

Senator **Durenberger**. Yes.

Mr. **Goldbeck**. One of the problems with the current tiering procedures is that originally, the formula that is now in the act was designed to help those governments that had the lowest income.

The way the tiering procedure works, and the result that occurs because of it, those governments within a county area that have the highest income are the ones that are getting the larger portion of the funds. So it is working just the opposite as was originally intended when the formula was first designed.

Senator **Durenberger**. Or another way of stating it is if you go back and adopt the same premise that I laid out under the fiscal disparities argument, that this is a way to insure adequate resources for States by recognizing that disparity exists, that same argument can be adopted within a State to local communities.

Now we have 10-plus years of experience in which we can actually see that if part of the notion of revenue sharing is to ease the inequities among local government jurisdictions—the inequities that come about because while one jurisdiction can't tax enough to meet its needs, somebody next door, because of the location of a large business or a utility or whatever, has a greater fiscal capacity—that there really is an equity argument here for making those detiering changes.

We are not hurting, in that sense, the few governments that would be allocated less revenue sharing—and I should add that under our hold-harmless provisions no government would actually receive less than it gets under the current system. But the detiering would not reduce their capacity to meet the needs of people who live in that community for education or police and fire protection or whatever their responsibilities might be.

Is that your general observation?

Mr. Goldbeck. Right. They would now be receiving the same amount of funds per capita as other cities in their State that have the same population, the same tax effort, the same per capita income.

So I think all we are saying now is let's treat everybody the same, all local governments the same within a given State so that if the formula is good, and we believe it is, then we ought to let it operate and not put in this tiering procedure which tends to limit everything that we attempted to achieve when we set the formula up back in 1972.

Mr. Fastrup. I would like to add one additional thing here.

If you accept the idea of correcting for fiscal disparities as one of the fundamental objectives of the program, I think the argument is even stronger at the local level than it is at the interstate level. Disparities among different communities in the same State are far greater than they are between Texas and Illinois or some other State.

The disparities are even greater within a State than they are between States, and, therefore, the rationale for making these changes is even stronger.

Senator Durenberger. But we also want to be careful to leave a lot of that responsibility to the States to help relieve it. We just don't want to continue exacerbating the disparity with a system that, as you people well know, actually does make the disparities worse than they have to be, and, therefore, only increases the burden of the State in remedying them.

My last question: I think I raised this with Dick Nathan, because he pointed out some apprehension about the sort of looseness that we left in S. 700 on determining the representative tax system formula; that maybe we were giving too much discretion to the Secretary of the Treasury. My answer was that any time we try to be too specific and put on all the nuts and all the bolts and all the screws and so forth, we tend to goof up.

Is the General Accounting Office satisfied with the provisions for designing the RTS that are currently in S. 700? If so, could you elaborate on why you think this is a desirable approach and why you are convinced that it would provide adequate safeguards?

Mr. Goldbeck. Our feeling is probably that you put on just about the right number of nuts and bolts. Somebody has to develop it, and Treasury, I think, is just about as good as anybody else, because it is their program. I think also you have placed some checks and balances on them by telling them to consult with ACIR, GAO, and the Department of Commerce, and if something happens and any of those organizations disagree with what Treasury is doing, I am pretty sure they are going to be coming back up here and telling you that there are some problems there.

You have also built into your bill the provision that either House can turn down the proposal that is coming from Treasury.

So, again, you have built in a check and balance to assure that when everybody has had a chance to look at it, there is a way of not allowing it to go into effect if there are some problems in determining it.

Senator Durenberger. Very good.

Thank you very much.

I appreciate your testimony, your response to the questions and your commitment to the program.

[Mr. Goldbeck's prepared statement follows:]

United States General Accounting Office
Washington, DC 20548

FOR RELEASE ON DELIVERY
EXPECTED ON APRIL 5, 1983

STATEMENT OF
ARTHUR R. GOLDBECK
ASSOCIATE DIRECTOR
GENERAL GOVERNMENT DIVISION
BEFORE THE
SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS
SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS
ON
GENERAL REVENUE SHARING PROGRAM RENEWAL

Mr. Chairman and Members of the Subcommittee:

We are pleased to appear today to comment on proposed formula changes contained in Senate Bill S. 700 which revises and extends the General Revenue Sharing Program. GAO has long endorsed the type of changes the bill makes in the allocation of funds to local governments. Our current work on allocation formulas, being performed at your request, also indicates that the bill's proposed changes to the interstate formula are appropriately designed to address the issue of fiscal disparities among States.

The bill proposes replacing the five factor and three factor interstate formulas with a new two factor formula based on population and tax capacity as measured by the Representative Tax System, generally referred to as the RTS. We believe this change would improve the targeting of Revenue Sharing funds among States.

The new formula would no longer use tax effort as one factor in allocating funds to States. Tax effort was originally included in the interstate formulas to reward those States which make strong efforts to raise revenue to provide needed services to their citizens.

There are two main reasons why tax effort could be considered an inappropriate factor in allocating funds among States. At a conceptual level, using tax effort introduces a bias toward providing services through the public sector instead of relying on the private sector. All States provide roughly the same public services--education, health, safety, parks and recreation, etc. Some States provide these services through the public sector while others rely more heavily on the private sector. Tax effort rewards those States that provide these services publicly and penalizes States in which the private sector provides them. Many would argue that Federal policy should be neutral regarding how States choose to provide these services.

At a more practical level, several States are able to export a portion of their taxes to out-of-State residents. Consequently, some States are credited with a high tax effort although the burden of those taxes are borne by residents of other States. Methods which could be used to correct this problem are controversial, so that, from a practical standpoint, this inequity may best be handled by simply eliminating the tax effort factor.

Our current work on allocation formulas concludes that, to neutralize fiscal disparities, Federal funds should be allocated on the basis of a fiscal capacity gap that measures States' revenue raising potential relative to a national standard. The new mathematical structure used in S. 700 measures such a revenue gap using a national standard equal to twice the average taxing capacity of all States. Because it is based on a revenue gap concept, we believe the new mathematical structure would improve the equitable targeting of Revenue Sharing funds. 1/

Finally, the use of the RTS as the measure of a State's taxing capacity would improve the equitable distribution of Revenue Sharing funds. Our recent report on the Medicaid Matching Formula 2/ compared the RTS to personal income as a measure of States' revenue raising capacity. We concluded that the RTS is conceptually better as a measure of tax capacity than personal income because the RTS attempts to account for all the major revenue sources typically used to finance State and local public services. The use of personal income assumes that all revenue sources are highly correlated with income. Research shows, however, that this is not the case.

There are certain limitations in the data and estimation techniques used in calculating the RTS. However, our judgment

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1/The present mathematical structure of the current formula is $\left[\frac{\text{U.S. tax capacity}}{\text{State tax capacity}}\right]$. The proposed new structure is $\left[1 - .5\ \frac{\text{State tax capacity}}{\text{U.S. tax capacity}}\right]$.

2/"Changing Medicaid Matching Formula Can Improve Distribution of Funds to States," (GAO/GGD-83-27, Mar. 9, 1983).

is that even with these limitations the RTS is a better measure of tax capacity than personal income. In recognition of the RTS limitations, S. 700 charges the Secretary of the Treasury, in consultation with the Secretaries of Commerce and the Interior, the Comptroller General and the Advisory Commission on Intergovernmental Relations, to develop an official RTS to be used in the new formula. We support this approach to developing an official RTS.

I would next like to turn my attention to changes in the formula used to allocate funds to local governments. The local three factor formula is designed to increase aid to more needy local governments, that is, those with large populations, low per capita incomes, and high levels of tax effort. In light of the proposed changes at the interstate level, shouldn't the same changes be made at the local level to provide a consistent means of addressing local fiscal disparities?

While elimination of the tax effort factor may be appropriate at the interstate level, we believe that it should be retained in the local formula--not to reward high spending but because at the local level it serves as a measure of the service responsibilities of local governments across the country. Unlike the situation at the State level, there are large differences in service responsibilities of local governments that the tax effort factor reflects. The tax effort factor therefore plays an important role in targeting funds to those local governments with greater need and should therefore be retained.

The mathematical structure used for tax capacity in the two factor formula is specifically designed to address the fiscal disparity issue. We believe this same structure should be used in the local formula as well. This would result in the consistent application of Federal policy toward both States and localities with respect to the fiscal disparities issue. Finally, while a more accurate measure of tax capacity for local governments would be desirable and, we believe, possible, collecting the data necessary to develop a local RTS for all eligible local governments would be prohibitively expensive.

Because the local three factor formula is fundamentally sound, equity would be served if the formula were allowed to operate with a minimum of limitations. We have recommended several changes to the local formula which would ensure that local governments with equal need would receive equal revenue sharing payments.

The first change I would like to discuss is detiering. With tiering, funds are first allocated to county geographic areas, divided into separate allocations for the various types of government in the county, such as cities and townships, and then allocated to individual jurisdictions.

Most of the funding inequities we identified 1/ can be corrected by eliminating the tiering procedure and allowing all local governments within a State to compete for funds from a single State allocation on the basis of their individual

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1/"Removing Tiering From the Revenue Sharing Formula Would Eliminate Payment Inequities To Local Governments" (GAO/GGD-82-46, Apr. 15, 1982).

characteristics of population, income, and tax effort. We estimate that detiering the formula would shift about 3 percent of total program funds and would signficantly improve funding equity for many local governments.

Our analysis revealed that tiering measures relative differences in the per capita income of a county area and its cities and townships. Tiering generally provides more revenue sharing funds to a county's cities if the average income for all the cities, as a group, is above that of the county area. Conversely, tiering provides less revenue sharing aid to a county's cities if the average income of all the cities is below that of the county area. Townships are similarly affected.

Consequently, where low income people are predominantly located in unincorporated rural county areas or in rural townships, such as in the South or Midwest, cities tend to receive more revenue sharing aid under tiering. In contrast, in States where urban poverty is a predominant pattern, such as New York and New Jersey, cities receive less aid with tiering than they would without.

The tiering inequities have motivated some New Jersey cities to change their governmental classification from city to township to increase their revenue sharing aid. The significant increases in aid resulting from such classification changes are obtained at the expense of other local governments in the same county because the revenue sharing payments to these governments are correspondingly reduced.

For example, the City of South Orange in Essex County, New Jersey, changed its classification to township in 1978 and South Orange's revenue sharing payment for the next year then increased by $248,000--a 351 percent increase. At the completion of our review in 1982, at least 10 other New Jersey cities had changed their classification to townships with subsequent increases in their revenue sharing aid.

Of course, the gains in aid realized by these communities are someone else's loss. Revenue sharing allocations to other cities and townships in Essex County declined. The City of Newark alone lost $1.5 million in revenue sharing funds as a result of the reclassification. The report we issued last April explains how tiering distorts the three-factor revenue sharing formula. We also have an explanation attached to this statement and would like to submit it for the record. To eliminate these distortions, we support the provisions of S. 700 that would eliminate the tiering procedure from the allocation process.

A second equity issue concerns the minimum and maximum per capita allocation provisions. Past research on the revenue sharing formula by GAO, the Department of the Treasury, and private researchers has demonstrated that the imposition of the minimum per capita allocation, equal to 20 percent of the State per capita amount, provides disproportionately large allocations to a number of limited service local governments. While these governments meet the Bureau of the Census definition of a general purpose local government, their governmental functions are extremely limited. The 20-percent minimum assures that these governments are funded far out of proportion to the governmental functions they perform. This reduces funds available to general purpose governments with a greater need for revenue sharing aid.

Provisions in S. 700 would lower the 20 percent minimum to 15 percent of the State per capita amount. While lowering the minimum to 15 percent would improve the allocation of funds, we believe consideration should be given to lowering it even further or eliminating it entirely.

Revenue sharing allocations are also subject to a maximum per capita amount equal to 145 percent of the State per capita amount. Past research has shown that this cap severely limits the allocation of funds to some of the Nation's fiscally distressed cities, such as New York, Philadelphia, Baltimore, and St. Louis. For example, in the most recent entitlement period, New York City received $272 million. If the maximum constraint were raised to 175 percent as proposed in S. 700, New York City would have received $301 million dollars, an increase of slightly more than 10 percent. Similar results would occur for other fiscally distressed cities. We support raising the 145 percent cap to 175 percent.

Another constraint limits the amount of revenue sharing aid a local government may receive to 50 percent of its adjusted taxes plus intergovernmental transfers. This constraint helps ensure that no local government becomes dependent on revenue sharing as its major source of revenue.

Research by GAO and other researchers have concurred with the basic intent of this constraint but identified refinements in its implementation which would improve its performance. For example, the inclusion of intergovernmental transfers in calculating maximum revenue sharing allocations means that governments receiving large intergovernmental transfers can also receive large revenue sharing payments whereas a similarly situated government that does not receive these transfers would have its revenue sharing payments limited. We suggest correcting this inequity by limiting revenue sharing payments to a percentage of the local governments' taxes plus user charges and varying the constraint with a community's per capita income.

The last issue I would like to discuss today is the inclusion of user fees into the local formula. In 1982 we reported that local governments have increasingly relied on user charges as a means of financing public services due to the passage of tax limitation measures enacted in the past few years. 1/ Because the current formula does not consider user charges, it does not respond to this shift in revenue sources utilized by local governments to finance government services. If user charges and taxes were both considered, the formula would better measure the revenue raising efforts localities undertake to provide public services. The targeting of revenue sharing aid would thus be improved.

1/"Including User Charges In The General Revenue Sharing Formula Could Broaden The Measure of Revenue Effort" (GAO/TAD-82-23, Sept. 2, 1982).

Our review also indicated that the Bureau of the Census does not collect user charge data for all units of local government. To do so would cost $300,000 annually. We believe this represents a modest cost that would significantly improve the equity of the program.

Mr. Chairman, that concludes my formal statement. We would be happy to assist the subcommittee concerning any of the issues I have discussed today and will be happy to answer any questions you or the subcommittee members may have.

EXPLANATION OF HOW TIERING DISTORTS REVENUE SHARING FORMULA ALLOCATIONS

The formula used for allocating revenue sharing funds to local governments uses three factors--population, relative income, and tax effort. By measuring taxes collected in relation to the personal income of its residents, the tax effort factor of the formula measures a jurisdiction's effort to help itself. The relative income factor of the formula adjusts for the fact that identical levels of tax effort would enable a higher income community to purchase more public services. The relative income factor serves to give less weight to the tax effort of low income communities, thereby compensating for the revenue raising advantage higher income communities enjoy. On the basis of these considerations, we believe the three-factor formula is fundamentally sound and provides a reasonable approach for allocating funds to general purpose local governments. However, while the three-factor formula is conceptually sound, the geographic tiering procedures used in the allocation process are a source of widespread inequities in revenue sharing payments.

In general, the "tiering" allocation process works as follows: within each State, revenue sharing funds are first allocated to county areas using the three-factor formula. Once the county area allocation is established it is subdivided, on the basis of taxes collected, into as many as three allocations--an amount for the county government, an amount for distribution to municipalities located in the county area, and an amount for distribution to townships (if any) located in the county area. Amounts established for distribution to the municipalities and townships are then allocated using the three-factor formula.

Our analysis has shown that, in effect, the tiering procedure is equivalent to adding a fourth factor to the basic three factor formula. This fourth factor allocates more funds to all cities within a county if the average income of the cities exceeds the average income of county residents living in the unincorporated areas of the county. Conversely, the fourth factor allocates fewer funds to cities within a county if the average income of all of the cities is less than that of noncity residents in that county. Townships are similarly affected in those States which have township governments. Thus, the fourth factor allocates more funds to the governmental group (county, cities, or townships) that has the highest average income in the county. We have termed the fourth factor the income disparity factor.

Mathematically, the income disparity factor is squared, which has the effect of magnifying income differences between a county, and its city and township governments. Thus, large differences in revenue sharing allocations result even when income disparities between the county and its city and township governments are modest. This phenomena occurs in two settings. It occurs in counties with large central cities with a large concentration of low income residents, such as in Newark, New Jersey, or Buffalo, New York. Such a situation produces a low average income for all cities in that county and they receive smaller revenue sharing allocations because the income disparity factor magnifies the relatively low average income of cities within that county. The second setting occurs in many rural counties. In those cases there are usually only a few small cities in a county and the city residents have high incomes compared to residents living in the remainder of the county. The high average income of the cities serves to provide them with large revenue sharing allocations due to the magnifying effect of the income disparity factor. The second setting most typically occurs in the more rural States of the South such as North Carolina and Tennessee.

Because the income disparity factor can be high in one county and low in another, we observed many instances where a high income city with low tax effort will receive a larger revenue sharing allocation than a low income city with high tax effort located in another county. In such situations, revenue sharing funds are being allocated in the opposite direction of that intended by the three-factor formula.

Senator **Durenberger**. The hearing will be in recess until 2 p.m.

[Whereupon, at 11:25 a.m., the subcommittee recessed, to reconvene at 2 p.m., the same day.]

AFTER RECESS

Senator **Durenberger**. We will reconvene the hearing of the Subcommittee on Intergovernmental Relations and our analysis of general revenue sharing.

Our first and only witness for this afternoon, as befits his status in this field, is the Governor of Vermont, Richard Snelling.

Governor Snelling is here this afternoon on behalf of the National Governors' Association, and as always, to share with us some of his own wisdom on intergovernmental fiscal relations.

We welcome you, Governor, and look forward to your statement. I have your printed statement, which, of course, will be made a part of the record.

You may proceed.

TESTIMONY OF RICHARD A. SNELLING, GOVERNOR OF VERMONT, ON BEHALF OF THE NATIONAL GOVERNORS' ASSOCIATION

Mr. **Snelling**. Thank you, very much.

Senator, I take great pleasure, as usual, in starting off my testimony by thanking you for your continued interest over time in the plight of States and local governments.

We wish it was more apparent to many in Washington that essential to any thoughtful process of redesigning the governmental system and dealing with the need for fiscal restraint is the assurance that every part of the governmental structure of the United States of America is prepared to function and to function properly.

Mr. Chairman, it is sad that the immense and important data about the plight of the States should need to be repeated at this time. It is in the printed record, and I just want to touch the surface, because I know that you are very familiar with it.

The reason why it is an appropriate starting point for any discussion of the Federal system or of any plan for revenue sharing with the States is because so much was said, at the time that revenue sharing for the States was ended, about the surpluses which the States had accumulated, and so little attention was given to the accounting systems of the States and how dramatically they differ from those of the Federal Government.

But suffice to say that if poverty is required to attract attention to the plight of the States, then revenue shortfalls in the last fiscal year for the States exceeded $7.9 billion. But it isn't just a dramatic number—particularly dramatic, I think, in the light of the capacity of States and the tremendous variety of that capacity.

What we should also note is the response of the States in a number of key areas to events in Washington and also, of course, to what has been happening to the people back home.

Of course, part of the responsibility to deal with the problems of unemployment and of recession falls to States and counties and local governments.

As I will point out later, it isn't as though the response of these entities can be separated. As a matter of fact, the essential capacity of counties and local governments to meet these needs depends on increasing support from the States.

In any event, since we started this whole process of reorganization, and since, as a matter of fact, revenue sharing for the States was dropped, we have seen a tremendous change in the relationship between States and local governments and of their responsibilities.

The response to revenue shortfalls has been increased taxes. It has not only been increased taxes, dramatic changes in the tax structure in 21 of the 50 States, but it has also been layoffs; it has been a substantial reduction of the work force of the people whose task it is to implement some of the programs which this Congress, in its wisdom, has designed over the years.

In addition to the shortfalls and the revenue increases and the layoffs, there has, of course, been a very, very substantial change in the way the States can and must and do use their money, and that change has been almost totally in the direction of increased responsibilities to State and local governments.

Mr. Chairman, the numbers are dramatic, and they are in print before you. The problem that you have a chance to consider is how we move from being responsive to these situations when they occur to preparation for a period in the future in which this severe test of capacity is not so likely to be presented to the States and to the local governments. Because the failures of capacity, failures of timing, failures of stability, can be very injurious to the people that they serve.

I am hoping that an appropriate starting place will be to think substantially about the overall relationship between the Federal, the State, county, and local governments, and I have done a very considerable amount of work in that area. There does not really seem to be, however, at this moment, any great likelihood of there emerging in this session of Congress or perhaps in the foreseeable future some thoughtful systems which measure responsibilities and capacities and compares those, one with the other.

What I believe is needed in order to assure a continued growth in the responsibilities discharged by States and local governments is some system which makes it possible for States to meet the needs which are not being met either by Federal grants or by the capacity to raise their own funds which, of course, varies dramatically from State to State. It is in that light that we hope that your efforts to restore revenue sharing for the States will be considered.

There really is a long-term place for revenue sharing, but aside from the long-term place, at this moment, in consideration of the overall budget structure, revenue sharing, which would permit States to make judgments about the areas of greatest need and which would enable them to address the incredible scope of the infrastructure requirements of the governments of the United States, could be of immense value.

Mr. Chairman, we have looked very carefully at your proposal to link revenue sharing with some changes in Federal tax expenditures. I am afraid that I must tell you we just haven't had an opportunity as an association to make a judgment, and so I am not able to bring you a conclusion or endorsement.

I can bring you two things: First, the reason why I would expect that the States would be leary of a proposal that had a cost, a bill, an invoice. Very simply, it is that the States have been willing partners in the task of trying to find a way to both meet the needs of the people of this country and yet keep the currency sound and the economic system sound.

We bargained honestly and have over and over again said about this measure or that, yes, if on one side the cost is this but on the other side the benefit is that, we would be willing to contribute to the solution to the deficit problem. So far, the bargains have often been one sided. Our offers long ago to accept some reduction in categorical grants in exchange for increased flexibility gave us the reductions in size without the flexibility.

We really were not prepared several years ago to lose revenue sharing. I am afraid that my colleagues would instantly respond to S. 700, which they will be studying at the earliest possible moment by expressing the fear that a 1-percent threshold for deductibility of State and local taxes today would be a 5-percent threshold tomorrow or a 10-percent threshold the year thereafter.

And the question is, how can States plan for the future?

How can they discharge the responsibilities which some in the federal system believe they should with a greater determination when there is no stability and when the ground rules are so hard to pin down?

Having said that, Mr. Chairman, I can only tell you that for myself, I have analyzed the proposal very carefully, and I think it is innovative. I think it is thoughtful, and I think it is fair.

I can make no claims as to how many of my colleagues will find it.

But I suspect that they will be somewhat moved by the gravity of the situation—$7.9 billion of lost funds or shortfalls is very significant to the States. The size of the infrastructure problem cannot even be measured by so gross a term as billions. One has to talk in dozens of billions or perhaps hundreds of billions to fully describe the infrastructure needs of the States, counties, and cities of America.

So for all those reasons, I would strongly support the general thrust of your proposal, S. 700. I hope that the members of your committee and of the Senate will see the timeliness of revenue sharing for the States at precisely the moment when the Governors are coming together with, I think, many other citizens of this country in expressing a determination to help you to bring about a more reasonable balance in Federal expenditures but at the same time an unwillingness to lose track of the States' responsibilities to make the programs that you design work.

I would like to answer any questions that I can, Mr. Chairman.

Senator DURENBERGER. Thank you.

One of the major things we talked about this morning was a new view on the function of revenue sharing. One of the first things I think we struggled with was the issue of the President's commitment to return resources to State and local governments, along with responsibility. Related to that was the function of the Federal income tax, and whether it related to that particular pledge. The President last year, as you well know, stopped short of involving the Federal income tax in his devolution of resources.

But in effect, we went back and looked at the role of the Federal income tax, and we did it on the assumption that all things considered, and putting aside the demand in this country for a flat rate tax and other objections to the current tax system, in its basic structure it is a much more progressive tax than any other tax; it is more progressive than our State income taxes and is certainly more progressive, or less regressive, than other State and local taxes.

As I have been sitting downstairs in the Finance Committee for the last 2 years chopping away at the income tax, trying to make it more equitable, one of the things that has been bothering me, as pointed out in your statement, is that in 1982 the States raised $3.5 billion in new taxes; in 1983, it appears that they might be raising $5 billion in additional taxes.

Mr. **Snelling**. Obviously, on the other side—I don't have the specific reference, but it is quite clear that as States restrain their local government, they are, in effect, raising property taxes and where local excise taxes are appropriate, those are going up.

Senator **Durenberger**. Then you indicate that in real terms or normal terms or whatever terms, Federal, general, and categorical aid to local government has dropped off 16 percent in the last 4 years.

The first question I have of you as it relates to the function of revenue sharing, I suppose, is, what do we do when we come out of the recession?

What do we do when all those jobs start coming back?

What do we do when income starts going up and tax collections start going up?

Is it likely that we are going to abandon the $3.5 billion in new taxes and the $5 billion in new taxes and the increases in property taxes?

Have we not, to some degree, shifted the tax burden for meeting the needs of the people in this country away from the progressive income tax to more regressive local taxes, and haven't we put all that in place ad infinitum?

Mr. **Snelling**. We have, Mr. Chairman, made our overall tax structure less fair than it was at the outset, and we have done so on the plane to which you refer but on several others, as well.

It is important to note that the States have not reduced their support of local governments who are in the period of their own financial problems. Between 1977 and 1981, State aid to local governments grew by 45.8 percent, while, as a matter of fact, Federal direct aid to local governments grew by only 35.6 percent during the same period of time.

Senator **Durenberger**. But that is not the best time period to use, because that is the period near the end of which we said you don't need State revenue sharing because you were rolling in the bucks and just passing them off to local government; isn't that correct?

Mr. **Snelling**. Well, that is true, but the trend has continued to a considerable extent. I have seen no evidence to suggest that the way States have restrained their own financial growth has been at the expense of local governments.

It is suggested that sooner or later it needs to be, and, of course, sooner or later, it will be, but at the moment, the pressure has been upward from local governments to State governments and downward from the Federal Government to State governments.

The reason that is particularly appropriate to your question is this: Clearly, the impact varies from State to State. Until such time as grants or considerations of what is equitable relys on studies of capacity measured by ACIR or any other standard, it is very clear that this devolution is far more fair in some places than others. Some States have three times the fiscal capacity of others in terms of where the additional burden of taxes will rest.

So, when the Federal Government reduces the income tax and States are asked to pick up these expenses, as you have pointed out, it results in terrible inequities in some places and not in others.

You say what will happen when everybody gets well? Well, when everybody gets well, we have got enormous bills to pay. We haven't been fixing the roof, Mr. Chairman. The infrastructure of this country has been falling in disrepair while we have been talking about restraint.

So, hopefully, we will get well. On the question of whether that means that we will be awash in cash as a result of these new tax levies, the answer is very clearly no, not if we do what we should be doing to build the strength of America for 10 years from now and we don't have to face these problems in a crisis atmosphere at that time.

Senator **Durenberger**. I appreciate the answer, and particularly your reference to fiscal disparities. I want to get to that in just a little bit.

But this statement of yours dwells on two priorities: One is jobs, and one is infrastructure. That is not to say that there aren't other problems. I just wanted to try to illustrate the developing quandry that some of us find ourselves in.

When Dick Nathan was here this morning, he complimented President Reagan for bringing about four positive events, if you will, in this whole intergovernmental system. One he called retrenchment; the second one he called a change of tone; the third was revising welfare policy, and the fourth was the devolution via States rather than via local government.

Now, we can disagree with that to a degree, but I think a lot of people have been complimentary of the fact that in the last 2 years, the President's leadership has in most areas put the squeeze on the expenditure side.

I would like to suggest that there are some people who have been here longer than I who feel that all the squeezing is taking place at this end and that despite everything you say, they don't see a lot of squeezing going on at your end.

Just by way of illustration and without picking on anybody, in your statement as you talk about the increase in State aid to local government as opposed to Federal aid to local government, you have several points, one of which is, in nominal terms, the States provided over three times the aid to local government in 1981 that the Federal Government provided, $70 billion, excluding passthrough, compared to $22.4 billion.

Second, the Bureau of the Census, in its Census of Government Statistics and analysis by ACIR, reveals that State aid as a share of local general revenue from all sources has risen from 41.7 percent in fiscal year 1954 to 63 percent in fiscal year 1980. The largest single category of aid is education, which represented 63.7 percent of all State aid to local governments in 1980.

That drops off to 11.2 percent for public welfare.

Somewhere over the weekend I read something—I don't know whether it was from the National Education Association or where it was—that State aid to education varies all over the lot from something like 83 percent local funding to 21 percent local in some States. I think in Minnesota it is, perhaps, 24 percent or 25 percent.

But there is an area in which you and your colleagues, I know, have expressed a great deal of concern, and that is whether or not the system isn't outspending itself in terms of the public rewards, if you will, for the amount of money that is going into the system.

Clearly, if you read Ronald Reagan or Terrell Bell, it isn't our job to involve ourselves in elementary and secondary education. It is your job and that of local school districts. But at very few State levels do you see anybody taking any action to improve that service delivery system. I mean, there are earth tremors in Minnesota because some Democrat, bless his soul, is about to introduce an educational voucher bill.

I am sure his hate mail is rising by the pound or by the foot. But some of your colleagues have ventured off—not too many of them—in exploring changes in that area.

I give you that not to be critical of the delivery system for education but to illustrate that there is more to our relationship than just how much money we deliver over to State or local governments; and that perhaps Ronald Reagan, when he does some tightening up in the system, is trying to force down through that system some response by way of change in delivery systems.

I know that is a broad subject but essential to the next set of questions I have to ask you.

Mr. SNELLING. It is an absolutely essential question in the light of our support for revenue sharing. It isn't really possible to isolate what States do for one particular social program or area of service.

Let's take the relationship between States and education and the proposition that States really should—most of them, I would say, are picking up a large share of the cost of education. But at the present time, they are having to make awful choices as to where to get the money to meet that responsibility, in part because of the haste with which this laudable goal of retrenchment has been undertaken.

Vermont, for example, has almost enacted its own jobs program. We waited for a period of time for the Federal Government to act. We are somewhat familiar with what the Federal Congress has produced.

We don't know all the details yet, as I believe nobody in America does, but very clearly more is needed on the State level to more precisely meet the needs in individual States.

Vermont has been picking up alcohol rehabilitation programs where Federal funds have been reduced. There are other programs which States are picking up because they believe they are vital to the interests of the people of those States, and every time they do, those are dollars which obviously, then, cannot go to the support of education in their State.

So once again, I believe there is a need for a mechanism which will address the range of differences between the States so the fundamental responsibilities of the States can be properly addressed and not be so shaped by the precise design of the Federal categorical grants system.

Let's assume that restraint is going to be here for a very long time. I do assume that. I think my colleagues do. We favor restraint rather than oppose it. It ought to be managed in such a way that it will endure and that will allow the system to continue to work.

If the system breaks down because the exchange of responsibilities between the States and the Federal Government is imperfectly developed, then the same special interests which came to Washington in the first place and overbalanced the Federal system by demanding these hundreds of narrow categorical grants and which demanded acceptance of the premise that only the Federal Government was an adequate guardian of these interests, will be back. Mr. Chairman, unless we are sure that even States with relatively low fiscal capacity and great need can find the resources to meet their new responsibilities without tremendously overburdening the taxpayers on the State and local level.

Senator **Durenberger**. I need to explore this, though, in the fiscal capacity sense. Capacity can mean two things: Capacity can mean that you have got several of your own spigots, plus another spigot labeled the Federal Government, and that flows in a variety of ways. Or capacity in the sense that we tie it to general revenue sharing can mean that we can do something about the actual disparity among the various States.

I am quite sure I know where you stand on the disparity issue, but I am concerned that a lot of your colleagues would interpret fiscal capacity in terms of having their own source of revenue plus a substantial flexible, certain—whatever these words are that you used—source of Federal funding, and a source that doesn't tell them how or where to spend it.

What is the current feeling among the Governors about, say, the use of general revenue sharing to ease fiscal disparities—to approach the capacity issue that way versus just, "give us back our revenue sharing"?

Mr. **Snelling**. Mr. Chairman, as you well know, the issue of disparity and of capacity is a relatively new one. Nevertheless, general revenue sharing is perhaps foremost among significant Federal grants.

ACIR has found a high correlation in the revenue sharing program between the size of the grant and the fiscal capacity or needs index of the States.

So, clearly, although it is relatively new, a revenue sharing formula tends to move in that direction.

You asked about the status. Well, the truth of the matter is that in that great golden era of the past when the Congress was able to listen to everyone's needs, add them up and send out the bill, it wasn't necessary to ask whether a State would be able to meet its responsibilities without Federal assistance.

If State "A" got the funds, State "B" got funds on the same basis.

Now, before we are through designing the system of restraint that will last and that will be supportable, it is clear that a new element has been introduced by the very nature of restraint. At this moment, I wouldn't be surprised if you found those States which have extraordinary capacity to be reluctant to admit that there should be any kind of a means test applied before the Federal Government helps States to meet their responsibilities.

On the other hand, if you look at it from a cold, analystic point of view, if you were to measure electoral votes, for example, you would find that there are enormously more electoral votes in States which would benefit from a capacity measure than there are that would be disadvantaged by the notion that they don't get Federal aid to help them solve problems before they have accessed to a reasonable degree the resources that are available through taxation in their States.

Senator **Durenberger**. There is a sort of halfway house we could hide in, I think, if we weren't really confident in being able to get to fiscal disparity, and I put in one of those halfway house bills a couple of weeks ago. It is called countercyclical fiscal assistance.

Do you have either a view on that bill or a general view on that kind of general purpose assistance for State and local governments where it is triggered by economic decline?

Mr. **Snelling**. Mr. Chairman, I always like appearing before you because we have read so many of the same things. Unfortunately, however, it is a disadvantage, however, because we must read the same ACIR studies on noncyclical measures, so I guess I should just say that I associated myself with their studies, and I am concerned about the tendency of specific countercyclical measures to bring the full force of the funds on stream at precisely the wrong time.

The goal is to even or to temper or to stabilize.

However, there is an awful lot associated with countercyclical measures so all is not lost in that field, which is good.

Senator **Durenberger**. Let me get back to the State formula for just a minute. I may have made a near-term mistake by designing the deductibility change as an "invoice," as you called it, for general revenue sharing, since everybody seems to want something for nothing these days. I know your justification is that we tend to promise a lot and don't deliver. But if you ask the taxpayers in your and my State, I think they will say that we have been delivering an awful lot, sometimes more than we promised; that we also promised, though, to make that delivery more effective. But that is not the point of my suggestion.

I am curious to know: If I hadn't designed an invoice or a specific bill into S. 700, would the National Governors' Association have spent some time in trying to redesign the formula for State general revenue sharing, or would it have been their position, "Put it back in with the old three-part formula?" And if the answer is the former, do you have some idea of what direction the Governors might have pressed us in the way of a formula?

Mr. **Snelling**. I think that the Governors would steadfastly support, as they always have in the past, an attempt to assign certain responsibilities or more of the fiscal costs of certain responsibilities to the Federal level and, on the other hand, a willingness for States to undertake more fully the financial responsibility of others, with some fundamental balance between the two.

We were not successful in negotiatting such a proposal in large part because of differing opinions of what takeover and full absorption of responsibility meant in the field of revenue sharing as a part of the total grant system. And we would not talk about revenue sharing as a financial source divorced from recognition of where we stand on the overall grant system.

Now, we suffered a loss of $13 billion in purchasing power in these direct grants-in-aid to State and local governments. Assuming the elasticity argument to which you referred earlier, Mr. Nathan's arguments and others to pronouncing material elastic is not to pronounce it unbreakable.

We have now, I think, absorbed the limits of our elasticity, and the advocacy which we have for revenue sharing, with or without some invoice or bill, is based in the context of overall grants to State and local governments.

We are not saying we would ask you to both hold the general grant levels steadfast and provide revenue sharing. We are saying, based on our earlier announced willingness to accept reductions in grants, revenue sharing makes sense and can make all the difference in the world in the feasibility of a project.

Mr. Chairman, let me just briefly refer to, again, I think the landmark action of the Governors at our most recent meeting where we agreed by a very substantial nonpartisan majority to a course of action to support Federal efforts to reduce the deficit. And in so doing, we made specific reference to grants for which we are the assumers. We suggested that all grants which were not tied to any kind of capacity measurement, any kind of a needs test, should be addressed differently than those which were designed on a needs test basis, and with respect to the broadest range of grants going to States, our suggestion wasn't full funding. It wasn't grants growing to offset inflation.

It was grants held to growth at three quarters of the rate of inflation. It is in that context that we think it is fair to talk about a revenue sharing without a separate detachable invoice.

Senator **Durenberger**. We have the President's New Federalism proposal this year in the form of block grants. I heard you testify on that on behalf of the NGA along with your chairman, and I think it has seemed to all of us a rather large package to be launching in the current environment.

Is it possible that there are some smaller packages that the President hasn't thought of or that could be pulled out of the separate blocks, or is it more realistic for us to look at one single block, for example, the transportation block, and concentrate on getting that right?

After you do the blocking, everything else is the kind of thing that you and I and others have dealt with over the last 35 or 40 hearings, and that is what strings are we going to attach to these programs?

But is it possible to design several smaller new Federalism blocks during the course of this year and to build into them certain kinds of the management tools that might lay some groundwork for the future of blocks?

Mr. **Snelling**. I think it is possible, Mr. Chairman, and the area in which block grants seem to have generated the greatest unity of feeling is transportation.

I think we are very close, on the Federal and on the State level, to having pretty broad consensus about the value of a block grant or one large block grant in that area.

There are two things that need to be addressed in designing further block grants in order to increase the likelihood of their winning wider favor.

The first, I think, is to make sure that we don't attempt to block items which are really quite different and address different needs of different clients. Some of the grants that have been proposed recently lumped together disparate programs, and I think that is a disadvantage and discourages the acceptance of block grants.

Second, so long as block grants are presented in the name of flexibility without flexibility, we continue to confuse people about what a block grant is. When you say a block grant is available provided that a State continues any program which it is presently offering in any of the following former categorical grant areas or that it back off at a rate not faster than *x* with no attention being paid to what the role of that particular categorical grant was in a particular State, it is very hard for the States and other governments to take seriously the notion of blocking.

We have really had much more use of the word "block grant" than we have had actual application of the concept, so far.

Senator **Durenberger**. One of the blocks we haven't seen yet but which seems to be floating around this place—I think your statement might help give a little impetus to it—is some sort of an infrastructure block.

I articulated this morning some of my concerns about this sort of thing. It was probably only because I have been through a gas tax hike on the day before Christmas and then an emergency jobs bill that nobody really believed in, but in which we all got little pieces for our State, and then we went home and tried to justify it as an emergency jobs bill.

It strikes me that a lot of this is just throwing money at a problem at a time when none of us have it or even understand the problem. You say you don't have any money; I know I don't. I am spending somebody else's money here all the time.

It seems to me there has got to be either a better way to do that, or some way, perhaps, to tie it into the kind of fiscal federalism issues that all of us have been concerned about.

The way we seem to be heading in infrastructure, we really don't answer the questions about what our roles are going to be in maintenance. We have got one role in construction, but we don't answer the problems of maintenance. We don't answer the problems on waste water treatment, about why a certain city is going to get 85 percent for its water treatment plant and some other city is only going to get 55 percent, or why we are willing to put 90 percent into Interstate Highways but only 55 percent into waste water treatment.

Those issues will never get addressed if we rush pellmell into the infrastructural solution.

It has been my notion that one way for us to participate in this process is not for us to do the bonding but for you to do the bonding, and we will help you out from the capital perspective. But we would also suggest that in exchange for doing that sort of thing you build the user fee system into some of these programs.

Then you could point to us as the "bad guy"—we were the ones that insisted on user fees—but maybe you could get over one of those political hurdles and some of the things that seem to stand in the way of the major infrastructural solutions.

Is there merit to that way of thinking?

Mr. **Snelling**. Of course there is merit, Mr. Chairman, but as you well know, it is a pretty complex problem, and it is difficult for any three people to get the same handles on it.

In the first place, I think we ought to start by recognizing the extent to which past infrastructure expenditures by the Federal Government have been largely designed to implement some Federal policy, in many cases to support a Federal mandate.

For example, there was a requirement that the water quality reach a certain level or that the air quality reach a certain level, with the standards having been set, in essence, by the Federal Government.

In many cases—particularly this is the case in water and sewage—the States received the message that they were required, in a reasonable period of time, to make these infrastructure investments, and the federally available funds were to encourage planning.

One of the things that has happened is that plans made at different levels don't mesh. One of the great needs here, to make the suggestion that you have made, I think, most viable is some kind of intergovernmental planning process. Because you are absolutely right: We cannot address the need at the moment and commit substantial funds to it only to find that some other need has a higher priority but the funds are no longer available.

But, Mr. Chairman, having said that I really don't like the notion, and I have fears about the idea of adopting a system which encourages States to undertake a whole new round of bonding.

Here it is terribly important that we recognize the difference between the latitude of the Federal Government and that of the States. You have the incredible luxury of debating whether $200 billion of deficits is too much or if $100 million of deficits would be better.

We don't have that capacity, and a very large number of States already have total bonded indebtedness which causes the bonding rating agencies to declare that regardless of Federal incentives, they have to shut off the approach to the borrowing window. Beyond that, the question of mixed signals intergovernmentally is very clear, because we are getting very definite messages from Treasury here and committees of the U.S. Congress that the competition of State borrowing with Federal borrowing is part of the overall problem.

The advantage—I see the disadvantage that you refer to, matching later maintenance and the like—but the advantage of a grant is that it is on the balance sheet. It is on the P&L. Presumably it is offered when someone has reckoned with what their total capacity is and with what the needs are, and there is something about it which does encourage addressing the most urgent problems first. That is a little harder to do when one has the notion of every year going to the borrowing window for a 20- or 25-year bond.

Senator **Durenberger**. I don't argue with that. I will argue, perhaps, with the first part of that premise which is that somehow or another it is better to leave the present system in place and recognize that it has created problems. That is, the system of tax-exempt-bonds financing and everything else, but let's not make too many more mistakes so the next time you go into a big issue for infrastructure, "You guys in Washington do it, and it will show up on the P&L and so forth."

My concern is that to adopt that kind of a strategy isn't going to change the current condition, which is that there is something like—I think last year—$70 billion in borrowing at the State and local level leveraged by the tax exempt nature of the bonds; $70 billion, and two-thirds of that went into people like the private company that can afford to be the largest advertiser in this country. We help private business sell hamburgers by subsidizing their interest payments, and you can go on and on and on.

You know where that started. It didn't start here. It started with your colleague Jim Rhodes in Ohio and with a variety of other people. Today, the battle to continue these subsidies to private business is being fought on the floor of the U.S. Senate by a former city councilman from Long Island who happens to be one of my colleagues.

Everybody seems to complain about the problem, particularly those who have to use the system because they don't have any other source of money to finance legitimate public capital projects.

I raise it as a part of the consideration of infrastructure.

Mr. SNELLING. I think a good place to start, Mr. Chairman, would be with some kind of intergovernmental planning process. It really is kind of astonishing that we have so little long-term planning with respect to the major big ticket purchases for the infrastructure of this country.

All too often, what has driven the system has been the willingness of the Congress to finance. In essence, the States have gotten, in the past, what the Congress thought we should get, not necessarily what we thought we should get. The money was available, and so if we are ever going to address that particular problem area, it was very tempting to do so at a time when the Congress deemed it to be worthy of funding.

So perhaps the point of reconciliation between these two systems of funding would be to see if we can come closer to agreeing on what the most urgent infrastructure needs are. The total is so great that the one thing everyone ought to agree to in advance is we are not going to meet the infrastructure requirements of all the people who reckoned infrastructure.

One plan, the Urban Institute analysis, indicates that we will require something like $660 billion in the next 15 years in State and local government infrastructure. That is, of course, more than has been spent in the last 20 years, and with the restraints that we are facing, the system for establishing priorities has got to be the key.

Senator DURENBERGER. I am going to conclude this, because I am sure you and I could spend the afternoon going back and forth on these issues.

But you would think there was something screwy with me if I didn't mention the subject of deductibility.

Since you and I have discussed the issue I will do it in the context of what seems to be on the immediate horizon.

You are right in saying it doesn't look like 1983 is a "big deal" year for issues in Congress. Once we get by the budget, everybody goes home or goes abroad and then we come back and do appropriations.

But the House is in the process of sending us over an abolition of indexing, eliminating the third year of the tax cut and a whole variety of things, plus a $30 billion a year revenue raiser, and I don't know yet what is going to happen to that when it gets here and into serious discussion.

But I think the possibility is perhaps in the 30–70 category today and rising, that we could be doing a second TEFRA. I would hope at that time that the Governors Association and others who have had the foresight to take a look at this funding mechanism for general revenue sharing may be in a position to give us some advice because, clearly, you are not going to make $30 billion on the backs of those who have to create jobs in this country. We aren't going to get it any more off of compliance, either, because the two compliance measures we tried, withholding and the other are failing miserably. So we are going to have to go after you and me as individuals, and that means starting back through the process of deductions and the largest of all is the deductibility for State and local taxes.

It is for that reason, and because of the threat that we had last year of the selective elimination of deductibility, that I felt this needed exploring. We will hear more about it tomorrow.

In structuring the deductibility change we put a floor on it rather than a cap on it so it doesn't interfere in any way with the decision-making at the local level. But I acknowledged this morning that if we were to make a big deal out of modifying deductibility, it could become an overblown issue like withholding and the reaction could overshadow the practical argument that I make of efficiency and national purpose and so forth.

I apprecite your willingness to take a look at that issue and ask others to take a look it.

Mr. SNELLING. We will do that.

Senator DURENBERGER. Thank you for your support of general revenue sharing and your willingness to share in all these other problems.

Mr. SNELLING. Thank you for your interest.

Senator DURENBERGER. Thank you, Governor.

[The prepared statement of Governor Snelling follows:]

PREPARED STATEMENT OF GOV. RICHARD A. SNELLING

Mr. Chairman and Members of the the Subcommittee:

I welcome this opportunity to appear before you today on behalf of the National Governors' Association to discuss the current fiscal relationship among the several levels of government and to describe what we believe the future holds for that relationship. I do so in my capacities as NGA's Lead Governor for Federalism and Chairman of the NGA Revenue Sharing Task Force.

The flow of funds between the federal government, the states, counties, and communities is but one mode of communication in the intergovernmental system. The Chairman's and the Subcommittee's sincere interest in the views of state and local governments is a fundamental element in the development of good public policy and the sound administration of our shared responsibilities.

Regarding intergovernmental fiscal relations, the key points I intend to make are as follows:

1. The current fiscal condition of the states is serious, as demonstrated by our budget and tax actions. Moreover, the immediate outlook is not encouraging, although recent indicators are positive.

2. The state-local relationship is a strong one, with a long history. Federal intergovernmental decisions too often have been shaped by the tension that exists between state and local governments, a tension I will argue is created largely by the limits within which each government must operate.

Regarding the future, the points I wish to emphasize are:

1. NGA federalism policy -- which has been influenced in part by concepts and initiatives of this Subcommittee and by your work, Mr. Chairman, in particular -- should be the framework for changes in intergovernmental affairs.

2. Flexibility continues to be one of the most valuable -- and elusive -- features of the intergovernmental system. We must look for new ways to incorporate it in the fiscal relationship between the federal government and the states.

3. Certainty is also a feature that we have not been successful in incorporating in the intergovernmental system. We should resolve this important problem.

4. The intergovernmental system faces some of the greatest challenges in its eventful 200 year lifetime in the coming decades. Two I wish to emphasize today relate to unemployment and infrastructure. Unless committed intergovernmental cooperation is achieved on these two issues, I believe that we cannot resolve the economic and income security problems that now face our country.

CURRENT INTERGOVERNMENTAL FISCAL RELATIONSHIP

Let me begin, then, with an assessment of the current fiscal relationship between the federal, state, and sub-state governments.

Fiscal Condition of The States

Any economic downturn tests the finances of state governments. The length and depth of the current recession, though now moderating, has created serious economic problems from coast to coast. As of January 1983, 41 of the 50 states are facing revenue shortfalls totalling $7.9 billion below their original estimates. Unfortunately, many of these forecasts seriously underestimated the length and severity of the recession, throwing state revenue projections badly off target.

For many states, the revenue shortfalls are extremely large, both in absolute dollars and as a percentage of their revenue base. These shortfalls have forced states to reduce expenditures and raise taxes. On the spending side, many have already implemented severe austerity plans. Thirty-three states have frozen or limited hiring, 18 have instituted layoffs, and 8 have furloughed workers. Many states have also scaled back cost-of-living adjustments or merit raises for state employees.

A majority of the states have also increased either sales or income taxes during 1982. During 1982, 14 states raised their personal income tax, 14 raised their sales tax, 6 increased their corporate income tax, and 12 raised their motor fuel taxes. Last years' tax actions are estimated by the Merrill Lynch Company to yield $3.5 billion in additional revenue. The company forecasts that in 1983, states will raise taxes by $5 billion. Indeed, work on 1983 tax increases is well underway. Since the beginning of the year, 13 states have raised taxes significantly.

The major reason for the spending cuts and tax adjustments has been the prolonged recession. But federal budget reductions have played an important role also. State and local aid from the federal government has declined in real terms between FY 1978 and FY 1982 by over $13 billion, or 18%.

To summarize this point, Mr. Chairman, most states are in a very difficult economic period. They are being forced to cut services and raise taxes, and federal budget cuts have compounded the problems. Relatively slow recovery and forecasts of high continued unemployment do not create an optimistic picture for the near future, although we are hopeful that the longer-range picture will improve.

To this end, Mr. Chairman, the Governors urged the Administration and Congress to develop a federal budget plan designed to reduce the out-year deficits and stimulate economic recovery. I have provided a copy of the policy we adopted for the record of these hearings.

State-local Fiscal Relations

There have been grave concerns raised recently regarding the fiscal relationship between state and local governments, particularly related to reforms in the federal aid systems such as block grants and other new federalism proposals. Generally, the concern is focused on whether the states are giving the locals a fair shake when programs are restructured to operate through state governments.

This concern has been expressed by Congress in the imposition of pass-through requirements in the block grants, limited transferability opportunities, allocating much of the emergency jobs funding directly to the local level, and eliminating the state role in revenue sharing. There have been major impediments to better state-local relations in recent years, and I believe that a major force behind much of the tension that has developed is the "bumping against the limits" of federal and state funds. Federal budget cuts, for example, that occurred in the creation of the nine new block grants in the Reconciliation Act of 1981, assured heightened conflict between the states and localities as the states were forced into a position of implementing the budget cuts.

The concerns are natural, but the fears are not borne out by past practices. States have provided in the past and continue to provide a very large share of local government finances.

Consider the following:

- According to the Advisory Commission on Intergovernmental Relations (ACIR), state aid to local governments grew by 45.8% from 1977 to 1981 while federal direct aid to local governments grew by 35.6%. These statistics exclude the estimated amount of federal funds that pass through the states to the local governments. In nominal terms, the states provided over three times the aid to local governments in 1981 that the federal government provided — $70 billion (excluding pass-through) compared to $22.4 billion.

- The Bureau of the Census, in its Census of Governments statistics and anaylsis by ACIR, reveals that state aid as a share of local general revenue from own sources has risen from 41.7% in FY 1954 to 63% in FY 1980. The largest single category of aid is education, which represented 63.7% of all state aid to local governments in 1980. The second largest category is public welfare, which comprised 11.2% of all aid in 1980.

- An National Education Association study found that this year, for the first time, states are paying more than half the cost of public education, providing an average of 50.3% of revenue. This compares to 40.7% ten years ago. Meanwhile, the federal share has dropped to 7.4%, the lowest in a decade.

Individual state actions bear out these aggregate statistics:

- The state of Ohio has recently raised its income tax by 90% through a surtax. Over $100 million will be earmarked for local programs;

- Michigan, the state that has suffered most during this recession, recently week raised its income tax by 38%, with 42% of the increase going to local communities. This is estimated to yield $400 million for local governments.

- Idaho's Governor Evans has proposed in his 1984 budget a one cent addition to the sales tax, 100% of which is to go to local government.

- Maryland has a number of programs primarily funded by bond issues which provide state assistance to local government for capital projects. Almost two-thirds of the state debt is for local facilities. In the last four years, Maryland authorized about $880 million in capital projects. Of this, 52% was for local facilities.

- Nineteen states have established an on-going intergovernmental advisory mechanism through which they regularly consult with their county and community officials.

THE FUTURE OF INTERGOVERNMENTAL RELATIONS

With the foregoing as background, Mr. Chairman, let me turn now to a discussion of the future.

Federalism Reform

This Subcommittee and the Governors are partners in the quest for workable measures for reforming the federal system. You are well aware, Mr. Chairman, that the Governors have developed a policy position stating the direction that we believe the reform should take. The basis of the NGA policy is that certain programs — in which need is driven by economic policy set by the federal government — should be funded by the federal government. The principal elements of our position are as follows:

- The centerpiece of a reformed federal system is a national policy on income security for the needy that incorporates a larger federal responsibility.

- The first step toward this policy is a federally-financed national program of medical care for the needy.

- To fund these programs and to preserve the current balance of costs within the federal system, the states remain ready to consider the orderly turnover to them of a comparably priced set of responsibilities such as education, community development, transportation, and social services.

- The federal government has a special role and responsibility to ensure that states have adequate fiscal capacity to meet federally articulated national goals, to work with states to meet the needs of special populations such as refugees, migrants, and Indians, and to assure equality of access and due process.

- The federal government should work to end the by-passing of state governments in local services programs.

This recession has again highlighted the wisdom of the Governors' recommendations that income security programs be primarily a federal responsibility. The fiscal facts are that as local and state economies contract, needs rise while resources decline. This has serious implications for state and local budgets, but the real pain is felt by the individuals and families who are unemployed.

Clearly, income security program reform, including Medicaid, should be the eventual goal of this Subcommittee, Congress, and the Administration. In fact, the Administration's New Federalism proposal, with some modifications that you and we suggested, recognized the need for changes in the way welfare and health care for the needy is addressed. The Governors are ready at any time to work on income security policies that move in the direction we have recommended.

Recognizing the difficulty in implementing such sudden and massive changes, we must also be prepared to move the federal system gradually towards a better sorting out and affirmation of federalism principles. Such movement should include:

a) federalism reforms such as increased flexibility and certainty; and

b) steps to insure that the economic climate is not creating undue hardship for states.

Flexibility

Mr. Chairman, we suggest that a focus of immediate intergovernmental reform efforts should be achieving greater flexibility in the intergovernmental system. As I noted earlier, this has been elusive, but I believe it is a pre-requisite to the wisest use of federal resources. State priority-setting should be a fundamental component of federal grants-in-aid. The following are the strongest opportunities we see for achieving the needed flexibility:

a) Reauthorization of General Revenue Sharing

We strongly support reauthorization of the revenue sharing program, including renewal of the state share. The program permits state-local priority setting, and, with the state share, recognizes the role of the three partners in the intergovernmental system.

States used revenue sharing for important purposes, which, by the way, were labor intensive. A survey by the NGA in the spring of 1979 indicated that over half the state funds were earmarked for education and social services.

The program has been administratively efficient and, in view of its size and wide distribution, has been reasonably successful in targeting funds. Very little of the funding is absorbed by federal administrative costs; specifically only 1/10 of one percent of the program budget in FY 1980. Regarding targeting, ACIR has shown that New York and Massachusetts, which have very high stress measures, received high per capita payments. On the other hand, Texas, with one of the lowest stress measures, ranked 47th in payments. The Commission also compared the annual revenue sharing receipts of central cities. It found that the program provided far greater per capita aid to cities than to their more affluent suburbs. For example, Detroit received $29.83 per capita, while Grosse Point Farms received $4.11. Cleveland received $24.32, and Beechwood City received $4.49.

b) Consolidation of Categorical Programs into Block Grants

The recent experience with block grants has been painful, with an overall reduction in budget authority of consolidated programs of 19% between FY 1981 and FY 1984. In view of these reductions, the increases in flexibility, limited as they were, have been useful in meeting state priorities. For example, in your state, Mr. Chairman, Governor Perpich transferred funds from the energy assistance program into the Community Services block grant to fund an emergency food and shelter program. Transfer provisions and priority-setting flexibility in block grants have enabled states to use block grant funds for programs of top importance.

So in spite of the drawbacks in the current consolidation experience we are reviewing the State Fiscal Assistance Block Grant (S 763) to determine how well it meets state needs. We are concerned that a 14% funding reduction is proposed, that unrelated programs are included, and that the fate of the federal funding after five years is uncertain.

The National Association of State Budget Officers (NASBO) is working on proposed revisions to the block grant that I can report to you on a preliminary basis. The NASBO proposals include:

- Setting the initial funding level at the sum of the 1984 appropriations for the incorporated programs.

- Establishing a permanent trust fund to which would be allocated the percentage of the federal income tax that would yield in the first year the amount set by the 1984 appropriations. (NASBO calculates this would be about 4% of federal income tax receipts.)

- Incorporated programs would be those proposed by the President, and so would the take-over mechanism.

- Beginning in FY 1989 the Trust fund would become a revenue sharing program, with the only restriction being that the funds would have to be expended for the program purposes of the twenty-two proposals.

- State government would continue to provide local government, in the aggregate, with funds proportional to those they historically receive.

- Discussions would continue with the President and Congress to have the federal government take over all or part of Medicaid in exchange for state assumption of a comparable dollar amount of categorical programs from the Revenue Sharing-Federalism Trust Fund.

You will note, Mr. Chairman, that some elements of the NASBO proposal are borrowed from your work on federalism. The NASBO members are reviewing the proposal, and we will report to you on any changes that are made.

c) Preserving the current treatment of state activities in the Internal Revenue Code

A key way for the federal government to preserve state-local flexibility is to aid state-local access to the capital markets and to avoid steps, in the current climate, that would create barriers to changes in state tax structures necessitated by the recession and by shifting federal costs to the states.

While NGA policy has not yet been established on the deductibility issue, it is my guess that the NGA Executive Committee will be reluctant to endorse any initiatives to limit deductibility by Congress. We have learned the hard way that times of fiscal austerity create poor climates for meaningful reform. We find we get the austerity without the reform.

In spite of this, I believe the revenue sharing - deductibility proposal you have developed (S 700) deserves careful review and study. It combines the creativity and careful analysis which are the hallmarks of your contributions to the deliberations of the Senate, Mr. Chairman. S 700 eliminates some of the problems of ending deductibility of one tax and not another. It permits greater progressivity of the federal income tax (by placing a heavier burden on high-income taxpayers) while alleviating the resulting burden on state taxpayers and tax systems (through its revenue sharing provisions).

As part of the review, we will be interested in learning more about the distributional effects of this proposal, both with respect to the impact on taxpayers at different income levels and the impact on taxpayers in individual states.

I look forward to working with you on this proposal and to a day when it can be debated in Congress on its merits.

d) The 95% Solution

As one final proposal for increasing flexibility, I offer an idea I have called "the 95% Solution." Under this proposal, Congress would set aside 5% of the funds it appropriates for categorical programs. This 5% set-aside would be earmarked for revenue sharing for state governments and could be used to "fill in the cracks" in the categorical system. I would be happy to pursue the concept with the Subcommittee at your convenience.

Certainty

In the past, appropriations bills have been enacted well after state budgets have been established, and you well know the problems created by the short lead time for implementing the block grants and the multiple funding revisions enacted through the reconciliation process in recent years. The solutions that have been suggested to the uncertainty issue in the past -- including advance appropriations, multi-year budgeting, and multi-year trust fund arrangements (as in the President's federalism proposals) should be examined by the Subcommittee.

Alleviating The State-local Impact of Economic Downturn

The data on the fiscal condition of the states illustrates starkly the effect recessions have on state budgets. In the short run, as a step toward federalism reform, and as a project related to intergovernmental fiscal relationships, we suggest that the Subcommittee review the federal role in the unemployment area and in capital infrastructure to determine how the federal government might alleviate some of the most intense recession-related fiscal pressures on states.

Employment Initiatives: The Congressional Budget Office baseline projects that unemployment will remain at or above 9% through 1985 and will not fall below 8% until 1988. Even if unemployment drops to the projected rate of 7.5% in 1988, there will still be 9 million Americans officially counted as unemployed. These estimates, which represent a middle range of alternatives, suggest that we will face very serious domestic policy problems in the years ahead. The current problems we face with the unemployment insurance (UI) system demonstrates clearly that UI is not capable of withstanding the challenge that we foresee. Let me begin by describing that challenge.

To begin with, the 9-10% unemployment figures do not count the discouraged workers and persons -- particularly youth -- who have never been in the workforce but are seeking jobs for the first time. Augmenting these structural unemployment problems is the fact that ten million American are functionally illiterate, and are therefore condemned to low-level, low-pay jobs. We must face these fundamental issues.

The structural problems described above, serious as they now are, will be exacerbated by a massive predicted increase in displaced workers. According to some estimates, between 20 and 30 million manufacturing and service workers will be displaced in the next two decades, yet efforts to respond to this shift are just barely getting underway, encouraged by the Job Training Partnership Act.

The inability of the existing UI system to provide stop-gap aid in the face of these shifts is demonstrated by the strain under which the system is currently laboring. In 1970, there were $11.9 billion in end-of-year reserves in the state benefit trust funds. The high volume and long duration of unemployment claims over the past decade have seriously eroded state benefit trust funds. The projected end-of-year deficit for state benefit trust funds in 1985 is $13.5 billion, signaling a serious deficiency in the funding of the system's benefit costs. The burden of these costs, by definition, falls on states that are suffering from the highest unemployment rates and therefore have the most limited ability to support the costs.

The UI system is the front line defense our governments offer citizens against the catastrophic effects of unemployment. However, it is not adequately financed to meet the challenges outlined here. Moreover, as I have pointed out, it will not touch the millions of workers who are discouraged or who are entering the workforce for the first time.

The Governors discussed this issue at our February winter meeting, and we have called for the development of a comprehensive employment policy through a partnership effort between the federal government, state government, and the private sector. The success of such an effort will directly and profoundly affect the intergovernmental fiscal relationship in the future. The initiative would include:

- assistance to displaced workers;

- youth work-to-school transition assistance;
- an improved vocational education system; and
- increased federal participation in the financing of unemployemnt benefits in states where rates reach catastrophic proportions.

Mr. Chairman, we know in no uncertain terms that unemployment creates tremendous strains in the intergovernmental fiscal system. It is vital, therefore, that this agenda-setting discussion focus on the trends in this critical area.

Infrastructure: By its recent actions, Congress has recognized that continued neglect of infrastructure repair will hamper the economic recovery which must occur if the current strains in the intergovernmental fiscal system are to be alleviated. The increased gasoline tax and some elements of the emergency jobs bill -- when combined with related state actions -- will permit some of the necessary work to go forward.

But there is still much to be done. In the last year and a half, every major newspaper and new magazine has run a story about the deterioration of America's capital stock. With ominous headlines like "The Decaying of America" and "State and Local Government in Trouble", these stories chronicle a ceaseless list of incidents of contaminated drinking water, broken sewage lines, dilapidated roads, bridges and dams. According to the Urban Institute, neglect in maintaining the country's existing infrastructure will push maintenance investment alone to over $660 billion in the next 15 years. The proceedings of the National Water Symposium notes, "This is as much as state and local government has spent on new investment in the past 20 years; it is equal to 20% of the entire U.S. gross national product in 1980." The financing of needed new systems would add to these costs.

Although state and local investment in infrastructure has grown dramatically (from $33 billion in FY 1971 to $53 billion in FY 1979), capital expenditures have declined from 21.8% of total state-local expenditures at the beginning of the decade to 15.7% in 1979. And it shows. While infrastructure needs -- and their impact on the intergovernmental fiscal system -- have been portrayed with fine chilling effect, the solutions are far less obvious and dramatic.

One possible starting point is a sound intergovernmental capital planning process. A capital plan helps clarify long term objectives, allows government to shape the direction of growth, and specifies courses of actions and the allocation of resources required to meet growth objectives. It permits review of maintenance needs vs new construction, the incentives built into federal matching requirements and related issues. While the "state of the art" is far from perfect, there are a number of innovative state programs that could serve as models for an intergovernmental capital budgeting approach, including those of Colorado, Maryland, Utah, and Vermont.

- In 1977, Governor Lamm of Colorado created a Colorado Futures Panel representing business, agriculture, education, labor and state and local government. The panel presented a detailed 20 year projection of future economic activity, capital investment needs, and state/local revenue collections. The recommendations guided the development of Colorado's 5-year capital investment plan.

- Governor Matheson of Utah established a long range planning process for that state in 1980 which ties capital budgeting to an overall policy framework.

- Vermont has prepared a 10 year capital program and capital budget since 1978 which provides a reliable basis for examining the state's policy on capital spending.

- Maryland has established a capital planning and financing program that features a centralized coordinated process for making state and local capital allocations.

The University of Colorado, the Institute for Urban and Public Policy Research, and the Joint Economic Committee of Congress have initiated an analysis of state infrastructure needs and financing capacity. The analysis is being conducted on a state-by-state basis. Each study will describe the condition of the state's capital stock, trace historical investment patterns for infrastructure and describe and evaluate the match between state fiscal resources and state infrastructure needs. Sixteen states are currently participating in the study and six others are likely to join. This study could be the basis of an effort to develop an intergovernmental capital investment plan and innovative ways to finance it.

The magnitude of the the public works problem does not lend itself to one quick solution. Innovative financing techniques alone will not fill the gap. Capital planning in itself will not solve the problem. Federal aid programs cannot cover all of the needs. Only a comprehensive, well-reasoned approach over an extended period of time will alleviate the enormous intergovernmental fiscal strains we have discussed here.

Because the Governors believe these two issues will be so important in the coming years, we have formed a Jobs and Infrastructure Task Force, headed by Governor James Thompson of Illinois, the next Chairman of NGA. Like this Subcommittee, the Task Force is cross-cutting in nature and is designed to draw together the good work Governor Riley has done on infrastructure and Governor du Pont's jobs-related projects into a cohesive policy. We all stand ready to work with you on this very crucial intergovernmental effort.

Mr. Chairman, the purpose of my testimony has been to provide a brief summary of the current fiscal condition of the states and of the major trends we believe will define the major intergovernmental fiscal issues in the future. In the spirit of the fruitful and open relationship between this Subcommittee and the Governors, I am available to you now to answer any questions you may have.

National Governors' Association

Scott M. Matheson
Governor of Utah
Chairman

Raymond C. Scheppach
Executive Director

NGA Position on Federal Budget

The nation's Governors are extremely concerned about the large federal deficits that are projected over the next five years. These deficits are projected by the Congressional Budget Office to increase from $197 billion in fiscal 1984 to $267 billion or 5.6 percent of GNP in 1988 in spite of the fact that real GNP is assumed to grow between 3 and 4 percent per year over this period. The major concern is that these deficits will increase interest rates, thereby slowing both the economic recovery and long-term economic growth. Without economic recovery, we cannot provide jobs for the millions of American men and women who need work and want to work. Without economic recovery, the already extremely serious fiscal conditions of the states will continue to deteriorate. State revenues are currently estimated to be off $7.9 billion, a drop of 5.4 percent from the estimates made in the Spring of 1982. Despite severe austerity measures, the states have not been able to offset recession-induced revenue declines. Thus, the states, as well as their individual citizens, have a vital interest in the timely resumption of real growth in the national economy. We, therefore, urge the Congress to enact policies this year to significantly reduce these out-year deficits. Specifically, we urge the Congress to:

1. Adopt a first budget resolution for fiscal 1984 which reduces the federal deficit to approximately 2 percent of GNP or $90 billion by 1988. The 2 percent level would eliminate most of the structural deficit and represents the average level experienced over the decade of the 1970s. It is also the consensus target adopted by a bi-partisan committee of business and government leaders. In developing the budget resolution most deficit reductions should be focused on the latter part of fiscal 1984 and the 1985-1988 period so as to not jeopardize the economic recovery.

2. Enact the authorization, revenue and appropriation changes in 1983 to achieve reductions throughout the 1984-1985 period. Spending and revenue changes have a cumulative effect and, therefore, changes are required this year to have even a moderate impact on the out-years. Delays in correcting the budget imbalance will contribute to uncertainty with respect to future interest rates and economic recovery.

3. Enact policy changes which share the burden among national defense and domestic spending reductions and possible revenue increases which do not unfairly burden already hard pressed, lower and middle income Americans, and do not shift additional costs to state and local governments.

Recommended Budget Guidelines

The Congress is urged to consider the following budget guidelines to attain the goal of reducing the 1988 deficit to approximately 2 percent of GNP. Such a strategy reduces the projected fiscal year 1988 deficit from $267 billion to $90 billion, a reduction of $177 billion in that year.

1. Social Security: Enact the bipartisan Commission recommendations on Social Security. These recommendations include delaying the cost of living adjustment from July to January, taxing 50 percent of Social Security benefits for high income individuals,

increasing the payroll tax and allowing a refundable tax credit, and increasing the self employed tax rate with 50 percent to be tax deductible. (Deficit reduction in 1988 = $24 billion from projected spending of $211 billion.)

2. Non-defense discretionary spending: Restrict the 1984-1988 increases to three-fourths the rate of inflation. This category includes grants to state and local governments, assistance to business and commerce, veterans' health care, environmental regulation, research and development, economic and military assistance to foreign governments and most of the costs to operate the three branches of the federal government. (Deficit reduction in 1988 = $11 billion from the projected spending of $184 billion.)

3. Means tested and other critical entitlement programs: Provide almost full funding for these programs including AFDC, food stamps, medicaid, SSI, child nutrition, low income veterans' pensions, guaranteed student loans (GSL), farm price supports, social services, general revenue sharing and unemployment insurance. (Deficit reduction in 1988 = $2 billion from a projected spending of $127 billion.)

4. Non-means tested entitlement programs: Restrain the growth in these entitlement programs which are projected to increase 60 percent between 1983 and 1988. Included in this category are the various medical insurance, disability and retirement programs funded by the federal government. (Deficit reduction in 1988 between $15 and $18 billion from a projected spending of $173 billion.)

5. National Defense: Limit national defense to between 4 and 6 percent real growth in appropriations over the 1984 to 1985 period and between 3 and 5 percent over the entire 1984-1988 period. The baseline and first budget resolution for fiscal year 1983 assume approximately 9.5 percent real growth over the next two years which is slightly below the Administration's request. Since defense spending has increased almost 57 percent over the 1981-1983 period some slowing of this rate may be appropriate to maintain cost-effectiveness in weapons systems and other procurement. (The estimated range of deficit reductions in 1988 is between zero and $19 billion from a projected spending of $358 billion.)

6. Revenues: Revenues may have to be increased enough to offset the remaining portion of the deficit to attain the goal of 2 percent of GNP. Revenues have already decreased as a percentage of GNP from 20.9 percent in 1981 to 19.0 percent in 1983 and are projected to decrease to 18.3 percent by 1988. The Governors do not, however, endorse any specific revenue proposal.

Summary of Recommended Budget Guidelines

Under current policy the deficit over the 1984-1988 fiscal year period will total almost $1.2 trillion which would approximately double the current federal debt outstanding. Under the NGA guidelines the deficits over this period would be reduced by $532 billion, of which about $169 billion would represent deficit reductions in non-defense programs and $294 billion would represent a combination of national defense reductions or revenue increases. An additional $69 billion would be saved over this period from lower interest costs from the deficit reductions. The NGA budget policy guidelines provide for a "downward glide path" to a deficit of approximately 2 percent of GNP by fiscal year 1988. This would leave a deficit of about $90 billion in fiscal year 1988 which is a $177 billion reduction from the baseline estimate for the deficit in that year. The year-to-year reductions and remaining deficits are shown below:

Deficit Reductions
(Billion of dollars by fiscal year)

	1984	1985	1986	1987	1988
Projected Deficits*	197	214	231	250	267
Total Deficit Reduction	27	77	114	137	177
Remaining Deficit	170	137	117	113	90

* These estimates do not include the $15-20 billion in off-budget deficits.

Adopted March 1, 1983.

Senator DURENBERGER. The hearing is adjourned.

[Whereupon, at 3 p.m., the subcommittee recessed subject to reconvene at the call of the Chair.]

OVERSIGHT OF GENERAL REVENUE SHARING

THURSDAY, APRIL 6, 1983

U.S. Senate,
Subcommittee on Intergovernmental Relations,
Committee on Governmental Affairs,
Washington, D.C.

The subcommittee met, at 9:40 a.m., in room SD-342, Dirksen Senate Office Building, Hon. Dave Durenberger (chairman of the subcommittee) presiding.

Present: Senators Durenberger and Levin.

Senator Durenberger. Good morning, ladies and gentlemen. The hearing will come to order.

This is the second day of hearings of the Subcommittee on Intergovernmental Relations on the subject of general revenue sharing.

I am very honored to have as our first witness this morning Congressman Frank Horton.

Congressman Horton is the ranking minority member of the House Government Operations Committee and has given long-standing leadership on revenue sharing and a variety of other very important intergovernmental matters. I understand Frank is also speaking this morning on behalf of the Northeast-Midwest Coalition.

Frank, thank you very much for coming over, and we look forward to your testimony.

If there is a printed statement, it will be made a part of the record.

TESTIMONY OF HON. FRANK HORTON, U.S. REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK, ON BEHALF OF THE NORTHEAST-MIDWEST COALITION, ACCOMPANIED BY JOHN DUNCAN, MINORITY STAFF DIRECTOR, HOUSE COMMITTEE ON GOVERNMENT OPERATIONS

Representative Horton. Thank you very much, Senator.

It is quite a pleasure and a privilege to be here this morning to testify before this subcommittee, and I would like to ask that my testimony be placed in the record, and I will read a short statement that I have that will summarize it.

Senator Durenberger. Without objection, it is so ordered.

Representative Horton. I would also like to introduce Jim Duncan, who is staff director of the minority side of the Government Operations Committee, who is here at the witness stand. I would also like to introduce Hon. Chris Lindley, who is a good friend of mine from Rochester, N.Y. I have known him for many years. He is a member of the Rochester City Council and will be speaking a little bit later this morning in the hearing on behalf of the National League of Cities on revenue sharing allocations.

I know that his contribution will be very significant. He has had a long history of support of this program, and I am very happy that he is here today.

I am pleased to introduce him to the subcommittee.

Mr. Chairman, I do want to thank you for inviting me to discuss general revenue sharing and various methods for reducing fiscal imbalance among the States and regions. Before I begin, I would like to commend you for your work on this subcommittee and in the area of intergovernmental relations.

Your leadership on this subcommittee and your participation on the Advisory Commission on Intergovernmental Relations have contributed substantially to improving the understanding of our Federal system both inside and outside of the Congress.

I would also like to begin by taking this opportunity to state my position on general revenue sharing.

As you know, on January 6, I introduced H.R. 616, which would extend the program as it presently operates for a period of 3 years. Funding levels would remain the same, and no changes would be made in the allocation formula. It would also remain an entitlement program. This is a companion bill to your legislation, S. 41. I firmly believe that a simple extension is the minimum effort we must make in renewing revenue sharing.

Early, strong support for these straight extension bills will send a clear signal to all involved that Congress will not let the program die. I think it is very important that we make that effort and try to prevent the addition of some of the things which could very well kill the program.

I also support the more comprehensive extension bill which has been introduced by Representative Ted Weiss, chairman of the House Intergovernmental Relations Subcommittee. Ted Weiss' bill calls for an increase in funding for the local government share. His bill would also return the States to the program under an entitlement basis and increase funding for them.

I might say also parenthetically that I have some fears of whether or not that is going to succeed. As you know, we had a big hassle in the last Congress the last time the program was renewed with regard to the States. Ultimately, they were removed from the provisions of the bill and are not now participating in general revenue sharing.

Personally, I would like to see them back, but I think that that might be too much for us to bite off and chew at this particular time. But I do want to indicate my support for the concept if it is possible.

I am also in the process of carefully examining your own broad ranging proposal for revising general revenue sharing contained in S. 700. I find it to be very innovative and worthy of serious consideration. As I understand the proposal, it would make revenue sharing a permanent program; simplify and redirect the allocation formula; revitalize the role of the States; and expand the size of the local share.

These are important changes that need to be fully discussed. To that end, I have directed my staff to review your bill for possible introduction in the House. Yet I hasten to add at this point that we cannot, as I have said many times before, love the program to death. A rush to improve and strengthen revenue sharing could fragment the fragile coalition that supports it and given opponents an opportunity to kill it.

That is why support for the simple extension bills, H.R. 616 and S. 41, is a prerequisite for either changing or enlarging the program.

This is not to say there is no room for improvement in the revenue sharing program. For a long time I have been concerned about continuing fiscal disparities between the poor and wealthy areas of the Nation. I firmly believe it is the responsibility of the National Government, under any view of the Federal system, to assist areas that, through no fault of their own, cannot finance public services.

In my position, as cochairman of the Northeast-Midwest Coalition, I have been even more concerned about these issues. This is one of the reasons why I am extremely interested in the approach your legislation takes. In a very comprehensive way it looks at using general revenue sharing as a means of assisting those parts of the country that are less well off.

This brings me to the focus of today's hearing: The representative tax system and how it might relate to revenue sharing.

As you know, the present revenue sharing formula, in determining how much is allocated to a government, takes into account the revenue raising capacity of that government and the extent to which that capacity is being used to finance services.

The poorer a government is, the more revenue sharing money is received. The more a government helps itself, the higher its tax effort; the more money it receives. The GRS formula uses personal income as a measure of the revenue raising capacity available to a government. The use of personal income as a measure for revenue raising capacity has been questioned.

The Advisory Commission on Intergovernmental Relations found that:

> The use of a single index, resident per capita income to measure fiscal capacity seriously misrepresents the actual ability of many governments to raise revenue.

To overcome this deficiency, the ACIR has developed another measure for estimated revenue capacity by estimating the amount of revenue the State and local revenue system would have generated had it made use of all its taxable resources.

This representative tax system, RTS for short, shows that per capita income, now used in the revenue sharing formula, overstates the revenue raising capacity of 22 States and the District of Columbia and understates the capacity of some 25 States.

In other words, the use of personal income instead of RTS as a measure of revenue raising capacity in the general revenue sharing formula results in almost 24 States getting less revenue money than they would receive under a more accurate formula.

Knowing the revenue raising capacity available to a local government is not enough, we must also measure the effort that a government is making to raise revenue. The present formula uses tax effort as a measure of the extent to which a local government is helping itself.

This present tax effort measure is misleading. It does not necessarily represent a State's actual tax burden because it makes no distinction between those taxes borne by residents within the State and those obtained from consumers in other States.

Disproportionalities are particularly great for States that can export their taxes, particularly energy-rich States and those with a heavy tourist trade. I might point out here that we got into some discussion of this matter in the subcommittee and full committee in the last renewal process in the House.

This so-called severance tax issue is a serious matter with many of the supporters of revenue sharing. It is a real problem, particularly with those States that are energy-rich. This is a very spirited and a very emotional matter, and we did not resolve it other than just to talk about it. But there is a very serious distortion with regard to the tax effort.

At first glance, these matters may look clearly regional, but the Northeast-Midwest Coalition does not believe this to be the case. Many of the governments that are losing money because of the use of personal income instead of RTS in the computation of revenue capacity are in the Southeast and are considered to be among the poorest in the country.

In an ideal world, the coalition would suggest that the measures of revenue capacity be changed to use the RTS approach instead of personal income, but we are not interested in getting into a bidding war, pitting one State against another.

We are not interested in polarized groups of winners and losers.

Finally, Mr. Chairman, in addition to the general revenue sharing bill, the coalition looks forward to action on the countercyclical bill to provide aid to State and local governments most adversely affected by the current economic downturn.

The need for this legislation among State and local governments in the Northeast and Midwest is very strong. In my own area, I would say that the general unemployment average is approximately from 8 to 13 percent, even in my own city of Rochester, N.Y. This is very high unemployment for our area, and there is a need to look at the countercyclical fiscal assistance program.

I would be concerned if we tried to hook it into revenue sharing, because I think it could be the death of both programs.

A program of fiscal assistance in response to economic conditions at the national, State, and local level will allow governments to avoid further layoffs, service curtailments, and tax increases.

I appreciate the opportunity to be here with you.

I might say again, with regard to the bill which you have introduced, S. 700, that there are some modifications that we are looking at.

I hope that we can resolve these modifications within the very near future so that I can introduce the bill in the House. The general things that I would be concerned about are: A retention of the measure of tax effort in the allocation formula, which I understand is not in your bill: and also, your bill provides for, I think, $11.5 billion, and we are looking at the possibility of a reduction in the cost of the program.

You have a 50–50 split between the State and local. We are looking at the historic split which was one-third State, two-thirds local government; possibly refraining from removing the State-local tax deductibility; and the possibility of not making the program permanent.

Those are the things that we are looking at now. Basically, we will retain the general provisions of the bill which you have already introduced and which I think is a good effort and something that we ought to look at as it relates to the formula.

Mr. Chairman, I thank you for your attention and your effort and what you are doing here, not only in the Governmental Affairs Committee, but also as a member of the Finance Committee.

Your leadership can be very, very effective in helping us on the Senate side to make certain that this program is moved forward.

I was talking yesterday to the chairman of our committee, Mr. Brooks, and he indicated that we problably will be taking up our end of the revenue sharing sometime before May 15. We want to have a full committee meeting, because that is when we have to report on our side of the Capitol. So, hopefully, we will have something in hand by the middle of May of this year.

Senator **Durenberger**. Thank you, very much, Frank.

I appreciate the testimony, and I appreciate your analysis of some of the realities that we are facing. I just came in from our Senate prayer breakfast and Jennings Randolph, who has been around for some time—he came in with F. D. R.—was there and he talked to us about humility. He said:

> Many is the time in my 10,000 votes that I have gotten up and thought that I had the right answers only to find out that somebody had a better answer in retrospect.

While I hate to admit it—I will only admit it on prayer breakfast morning—that is the way I feel about S. 700. There may be a better answer to this problem. I just haven't happened to see it yet. I would just hope that we are realistic enough to know that by May 15 we are not going to pass a major change in the theory of general revenue sharing, but that in the near future everyone who has a stake in redesigning this Federal system so it works better must take a look at revenue sharing and try to improve on it. It is sort of a challenge to everybody to do exactly what you and your staff and other people have done: To see if you can find a better way to do it.

Representative **Horton**. Could I add to what you just said?

Senator **Durenberger**. Yes.

Representative **Horton**. I do feel that what you say is very important, and what we have a tendency to do is as soon as we pass the bill is say, "Well, now, we have got it into place." And so we don't look at it again until it comes up in the future.

With your leadership here on the Senate side trying to improve it, I promise you that I will do the best that I can on our side, the House side, to try to look at it, too, in this interim period. I agree with you that the allocation formula, as I indicated in my prepared statement and also what I testified to here, does need some changes; it is very unfair, and yet at the same time it was put together at a time when there had to be compromises, and it has worked; it does provide a means of getting funds to local governments.

But as the testimony indicated and as you know, there are some 25 States that are really not participating as fairly as they should be. We should make certain that it is a fair program.

So I think it is important that we direct our attention to improvement of the program and not just let it slip by when and if we pass the extension.

Senator **Durenberger**. I think one of the difficulties we are going to experience this morning—and you have probably heard it all before in hearings—is that this is a relatively uncertain time when Congress doesn't necessarily do rational things.

Back in 1980, we kicked the States out of the program because they were all running surpluses. This year we don't want to let them back in because we are running a big deficit. Really, those two issues have nothing to do with what it is that we in these committees are charged to do, and that is to build a stronger fiscal foundation under this partnership between the Federal, State, and local government.

I was pleased to hear you speak for the need to reanalyze the allocation system, to look at the whole issue of fiscal disparities, of whether there is a better formula that addresses that problem and, in speaking to the people from local government who are going to be appearing here today, to look positively on the role that the States could play in this whole area of State revenue sharing.

Local officials, I think, are concerned that there is a traditional Republican orientation to deal with Governors and to say, "To heck with local government," and if you can wait until the Democrats get in here, then they deal with local government.

In the testimony we had here yesterday, I think a lot of people agreed that that may have been the course in the past, but that the whole theory of revenue sharing is likely changing and that the States are taking on a different kind of role in helping to finance the delivery of public services at the local level. We have to look at revenue sharing in that kind of a context to strengthen that hand that State government has to play.

As I have stated before, I am hopeful that if the best we can do is a minimum reauthorization along the lines of the two bills that you and I introduced, it must also send a signal out to everybody that they are going to have to get back here and seriously address whether or not we somehow created a perfect system in 1972 that doesn't need change, or if it can be changed and improved on. We don't want to wait 3 years to change it or to improve on it.

So there is a real, live possibility for discussion on this side and in the Finance Committee and in the administration, from which we haven't heard much on this issue.

Representative **Horton**. I would like to comment on that. I haven't heard too much from them.

There has been general support. As a matter of fact, when I put my bill on the House side and you probably did on the Senate side, we cleared it with the administration to let them know what we were planning to do. They indicated that they had no objection to that, although there has been some conversation which would indicate that they would like to have a 5-year extension.

But they, in turn, are also talking in terms of a block grant type——

Senator DURENBERGER. Right.

Representative HORTON [continuing]. Merging the community development and revenue sharing. I understand from one of the persons that has been at the subcommittee hearings on the House side held just this last week that there is some opposition out there with regard to this proposed consolidation.

It is my general view that general revenue sharing is a very important ingredient in the municipality's ability to provide services and that from my standpoint, it is head and shoulders above other types of programs.

It is even better in many instances than the block grants. Yet, I do, in general, favor the block grant approach because there is a lot less bureaucracy and it is a more efficient means of providing support from the Federal level.

But general revenue sharing is administered, as you know, with a minimum of bureaucracy; with a very small staff and yet some 39,000 units of government participate.

In my conversations with my local governments, as I went around for 3½ weeks in January and February in my district, I saw over 3,000 people, and many of those people were local officials and were telling me how they used this money.

It is used generally in capital improvement programs which they could not do, without revenue sharing. So it does save their local taxes for other purposes.

It is a very important program, and I certainly agree with you that we need to continue it, but I also emphasize again a need for making it more equitable and more fair.

Senator DURENBERGER. Thank you, very much.

I appreciate your coming over.

Representative HORTON. Thank you.

Senator DURENBERGER. John, thank you for coming over.

[The prepared statement of Congressman Horton follows:]

PREPARED STATEMENT OF HON. FRANK HORTON, COCHAIRMAN, NORTHEAST MIDWEST CONGRESSIONAL COALITION

Mr. Chairman, members of the subcommittee:

As co-chair of the Northeast-Midwest Congressional Coalition I welcome the opportunity to appear before you this morning. I wish to thank you and members of this subcommittee for scheduling hearings on one of the more important pieces of legislation to come before Congress this year: the renewal of the general revenue sharing program.

History has taught us that the battle for reauthorization of this fiscal assistance program will be long and hard-fought. I was present at the beginning of revenue sharing and fully recognize the difficulties of passing a general revenue sharing bill. The revenue sharing program, first approved in 1972, was not reauthorized until the very day it expired in 1976, and in 1980 it was not reauthorized until almost two-and-one-half months after it had expired. Revenue sharing currently is set to expire on September 30 of this year, and its quick reauthorization is critical to the fiscal well-being of local governments.

At the outset, I also would like to express my personal appreciation to you, Mr. Chairman, for your leadership and active involvement in reauthorizing the general revenue sharing program. I commend you for the early introduction of S. 41 -- which now has more than 70 co-sponsors -- to extend the current program for three years at present funding levels. As you know, this legislation is similar to H.R. 616, which I introduced on January 6. I hope the broad, bipartisan support shown for these measures will send a clear and unequivocal message that to members of Congress the current program is the minimally acceptable alternative

Revenue sharing is an essential part of the life-support system of governments throughout the nation. It gives them maximum flexibility to respond quickly to the pressing needs of communities with divergent economic problems.

This discretionary money is particularly important to those areas most severely affected by the national economic downturn. Indeed, in the Northeast-Midwest region, which has received some $33.7 billion under the program since 1972, revenue sharing has been a lifeline for financially strapped communities. For most local governments, general revenue sharing is the only program under which they receive any federal assistance. And although the program's funding level has not increased since 1976 -- resulting in a 52 percent decrease in spending power -- it can be argued that many local governments find revenue sharing funds more essential than ever before.

A January 1983 National League of Cities survey found that:

- general revenue sharing is the only federal grant received by 62 percent of communities with populations under 10,000; 39 percent of the communities under 50,000 indicated GRS was the only federal grant received;
- GRS payments equal an average of 6.3 percent of locally raised revenues, but as much as 9 percent or more in small cities;
- to replace a loss of general revenue sharing funds, property taxes would have to increase about 25 percent in most communities, but by as much as 50 percent in communities with under 10,000 population;
- 80 percent of communities surveyed would have to cut services if revenue sharing funds were reduced next year, and at least half of them also said they would have to raise taxes.

The recession and cutbacks in other federal assistance programs have greatly increased the burden of responsibility on local governments. This makes re-authorization of general revenue sharing this year even more important. Failure to do so will result in service cutbacks and tax increases at the local level.

Mr. Chairman, I come before you today not only to reaffirm my long-standing support for the general revenue sharing program, but to reaffirm the principles I think should be considered during reauthorization. First, I would like to see revenue sharing payments to state governments restored. The Congress made an error in dropping the states from the program in 1980. At that time, the Coalition warned that: "Dismembering the revenue sharing program is not fiscal restraint -- it is fiscal irresponsibility. . . .Eliminating the state share of general revenue sharing will tighten by a notch or two the fiscal straight-jackets of many Northeastern and Midwestern states." Second, I would increase annual revenue sharing allocations to adjust for the loss of purchasing power due to inflation since the program last was reauthorized in 1980. These two improvements are contained both in your expanded revenue sharing bill, S. 700, and in H.R. 1930, a five-year reauthorization bill introduced by Representative Ted Weiss and of which I am a co-sponsor.

I am convinced that increased revenue sharing funds spell the difference between fiscal security and mere survival for many governments throughout the nation. Economic conditions in the country have reduced significantly the ability of state and local governments in the Northeast-Midwest region and elsewhere to provide adequate levels of services. These revenue sharing funds would give them the flexibility to respond to the genuine needs of their citizens in the most efficient manner.

State and local governments throughout the nation are facing difficult fiscal times as a result of decreases in revenues, increases in social program costs, and reductions in federal assistance. These problems are compounded by the high interest rates and reduced attractiveness of state and local bonds, shrinking tax bases, and the prospects of further cuts in federal aid.

In its study of Trends in the Fiscal Condition of Cities: 1980-1982, the Joint Economic Committee found that the fiscal health of cities has deteriorated steadily in recent years, in line with deteriorating economic conditions. Last year's report showed that the number and proportion of cities running operating deficits had reached a crisis stage. In 1981, two out of every five cities surveyed reported deficits; in 1982, that figure rose to 59 percent.

A 1983 survey by the National Conference of State Legislatures gives ample evidence of the worsening condition of state finances. It found that 19 states are projecting actual deficits at the year's end and 12 others have a slim surplus of less than 1 percent of their annual budgets. Another survey by the National Governors' Association shows that not all state governments are affected equally by economic difficulties. The 18 states in the Northeast and Midwest expect their ending balances to decline from a cumulative $9 million surplus after 1982 to a $1.9 billion deficit after fiscal 1983. Only nine months ago, this 1983 deficit was predicted to be $639 million. In contrast, a number of states in the South and West expect sizable surpluses, and most of these -- including Alaska, Oklahoma, Texas, and Wyoming -- derive significant income from taxes on the production of minerals, oil, or gas.

It is imperative that we reauthorize the general revenue sharing program. Our state and local governments will face hard times in the next year. We must retain the vital partnership between the federal and local governments -- and restore states to the program -- to ensure that our communities will be able to meet the basic needs of our citizens.

Mr. Chairman and members of the subcommittee, as you know, I am a staunch supporter of revenue sharing and, in the past, have always argued against any radical changes in the program or any modifications in the allocation formulas. I have warned local officials: "Don't love it to death. . . .It's my real fear that the major supporters of the revenue sharing program will fragment themselves so badly attempting to improve the program that they will render themselves ineffective in getting the program reauthorized."

However, as co-chair of the congressional coalition representing the Northeast and Midwest -- a region that lost revenue sharing funds this year -- I would be remiss if I did not point out the most troublesome aspects of the interstate formula and suggest refinements that could be made to insure the fairest and most equitable allocation of general revenue sharing funds. Many states in the Northeast and Midwest -- such as my own state of New York, Michigan, and Rhode Island -- as well as many in the Southeast -- including Alabama, North Carolina, and Georgia -- currently do not receive their fair share of funds.

Local governments in the Northeast and Midwest lost $53.6 million in payments between fiscal 1982 and 1983 due to a variety of factors that enter into the current formula. (The attached table breaks these figures down on a state-by-state basis.) For example, jurisdictions in states that lose population or experience slow growth lose GRS funds. As the amount of money they receive decreases, so does each locality's ability to address economic problems often associated with slow population growth.

But the most serious flaws in the interstate formula are its measures of tax capacity and tax effort. The current formula correctly includes a tax effort measure on the theory that if a state makes an effort to raise money on its own -- by taxing its residents -- it should be rewarded by the federal government. A state's tax effort is derived by dividing the total taxes collected within a state by total personal income. Personal income is used as a proxy for a state's tax capacity -- its ability to raise revenue to provide services.

However, this tax effort measure can be misleading. It does not necessarily represent a state's actual tax burden because it makes no distinction between those taxes borne by residents within a state and those obtained from consumers in other states. Distortions are particularly great for states that can "export" their taxes, including energy-rich states such as Alaska, Texas, Louisiana, and Wyoming and tourist-rich states like Nevada, Florida, and Hawaii. Indeed, had the severance tax Alaska imposes on its energy production been excluded from its measure of capacity and effort, its tax effort would have registered 81 percent of the national average instead of 166 percent.

Furthermore, the use of a state's total personal income as a proxy for its tax capacity has drawn increasing criticism in the past few years. The Advisory Commission on Intergovernmental Relations (ACIR) found that "the use of a single index, resident per capita income, to measure fiscal capacity seriously misrepresents the actual ability of many governments to raise revenues." Income is only one of the bases on which state and local taxes are imposed. Other significant sources, such as state corporate taxes, property taxes, severance taxes, and sales taxes, are not -- but should be -- figured into the tax capacity measure.

To overcome this deficiency, the ACIR has developed another measure for tax capacity -- and, thereby, tax effort -- by estimating the amount of revenue the state-local revenue system would have generated had it made use of all its taxable resources. This "representative tax system" (RTS) approach shows that per capita income overstates the revenue-raising capacity of 22 states and the District of Columbia, is neutral with respect to another 3 states, and understates the capacity of the remaining 25 states. The table below shows those states for which the income index overstates and understates tax capacity.

1980 Tax Capacity Indexes:
Per Capita Income (PCI) versus Representative Tax System

Overstated by PCI[1]		Understated by PCI	
Alabama	New Jersey	Alaska	Montana
Arizona	New York	Arkansas	Nevada
Connecticut	North Carolina	California	New Hampshire
District of Columbia	Ohio	Colorado	New Mexico
Georgia	Pennsylvania	Delaware	North Dakota
Illinois	Rhode Island	Florida	Oklahoma
Indiana	South Carolina	Hawaii	Oregon
Maine	Tennessee	Idaho	South Dakota
Maryland	Virginia	Iowa	Texas
Massachusetts	Washington	Kansas	Vermont
Michigan	Wisconsin	Kentucky	West Virginia
Nebraska		Louisiana	Wyoming

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[1] The RTS and per capita income measures are neutral for three states: Minnesota, Mississippi, and Missouri.

In other words, the use of income instead of RTS as a measure of tax capacity in the general revenue sharing formula results in almost two dozen states containing 56 percent of the nation's population getting less revenue sharing money than they would under a more equitable formula.

current economic downturn. The need for this legislation among state and local governments in the Northeast and Midwest is strong. Within a nation in recession, we are a region in depression:

- In December 1982, the Northeast-Midwest region as a whole had an average unemployment rate of 13.3 percent, compared to the national unadjusted rate of 10.5 percent. The problem is particularly acute in the Midwest, where five of the seven states had unemployment rates above the national average, topped by Michigan at 17.3 percent;
- Perhaps as significant as overall unemployment is the long-term rate, which in recent years has emerged as a regional problem. In 1982, the Northeast and Midwest, with 45 percent of the nation's population, had over 56 percent of the long-term unemployed. Almost one-third of those out of work in the region had been jobless for more than 15 weeks; and
- The 50 states owe the federal government $10.6 billion for unemployment compensation; 93 percent, or $9.8 billion, of that debt is owed by states in the Northeast and Midwest.

Mr. Chairman, a program of fiscal assistance that responds to economic conditions at the national, state, and local levels would allow governments to plan for economic stability and recovery and help them avoid further layoffs, service curtailments, and tax increases.

Thank you for the opportunity to be here today. I would be glad to answer any questions you might have about our proposals concerning the general revenue sharing program.

At first glance, Mr. Chairman, this may look like a clearly regional issue. The Coalition does not believe it is. Many of the states that are losing money because of the use of personal income instead of RTS in the tax capacity and tax effort measures -- including Alabama, North Carolina, South Carolina, Georgia, and Tennessee -- are in the Southeast and are considered to be among the poorest in the country. Mississippi, last in the nation in terms of fiscal capacity, would receive the same amount under either the income or RTS measure.

In an ideal world, the Coalition would suggest that the tax capacity and tax effort factors in the formula be changed to use the RTS approach instead of personal income. But we are not interested in getting into a bidding war, pitting one state against another. We are not interested in a polarized group of winners and losers.

Therefore, the Coalition has developed a compromise proposal. We suggest that in the reauthorizing legislation we allow a state to use either measure of tax capacity -- personal income or RTS — to determine its allocation. Each state then would be allowed to take the allocation that yields the higher amount. We hope that by expanding the pot of money for the program, we can avoid doing damage to any one state and hold all states harmless at their current levels. Staff members of the Coalition currently are calculating the amount each state would receive under this system, and with your permission, we would like to submit those numbers for the hearing record as soon as they are available.

Mr. Chairman, in addition to passage of a general revenue sharing, we look forward to action on a countercyclical fiscal assistance bill to provide anti-recession aid to state and local governments most adversely affected by the

GENERAL REVENUE SHARING ALLOCATIONS, FISCAL 1983
(in millions of dollars)

Region and State	Fiscal 1982	Fiscal 1983	Change, 1982-1983 Amount	Change, 1982-1983 Percent
NEW ENGLAND				
Connecticut	55.346	54.211	-1.135	-2.1
Maine	28.283	28.417	.134	.5
Massachusetts	140.831	137.125	-3.706	-2.6
New Hampshire	14.271	13.982	-.290	-2.0
Rhode Island	19.559	19.624	.065	.3
Vermont	12.633	12.803	.170	1.3
Total	270.922	266.161	-4.761	-1.8
MID-ATLANTIC				
Delaware	13.838	13.429	-.408	-3.0
Maryland	87.252	87.899	.647	.7
New Jersey	149.004	144.346	-4.658	-3.1
New York	481.693	465.305	-16.388	-3.4
Pennsylvania	226.426	222.312	-4.114	-1.8
Total	958.213	933.290	-24.922	-2.6
MIDWEST				
Illinois	222.365	213.047	-9.318	-4.2
Indiana	83.200	86.018	2.818	3.4
Iowa	56.168	54.795	-1.373	-2.4
Michigan	181.991	175.584	-6.408	-3.5
Minnesota	86.568	84.753	-1.815	-2.1
Ohio	180.869	173.162	-7.707	-4.3
Wisconsin	97.632	97.526	-.106	-.1
Total	908.794	884.884	-23.910	-2.6
NORTHEAST	1,229.135	1,199.451	-29.683	-2.4
MIDWEST	908.794	884.884	-23.910	-2.6
NORTHEAST AND MIDWEST	2,137.928	2,084.335	-53.593	-2.5
SOUTH	1,333.578	1,370.608	37.031	2.8
WEST*	1,095.194	1,111.756	16.562	1.5
SOUTH AND WEST	2,428.772	2,482.365	53.593	2.2
U.S. TOTAL	4,566.700	4,566.700	.000	N/A

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* Figures for Missouri are included under West: Fiscal 1982 - $81,797 million; Fiscal 1983 - $78,873 million; Change, 1982-1983 - $2,924 million.

SOURCE: Staff calculations from unpublished data, Office of Revenue Sharing, Department of the Treasury, September 1982 and *Thirteenth Period Entitlements -- General Revenue Sharing*, Office of Revenue Sharing, Department of the Treasury, August 1981.

Senator DURENBERGER. Our next witnesses will sit together as a panel. They are experts on the representative tax system. Bob Honts, Travis County Commissioner, is here to speak on behalf of the Texas ACIR; Mr. John Shannon is a ranking expert at ACIR on the representative tax system; and we are particularly delighted this morning to welcome Mr. Douglas Clark who is representing the Canadian Government. Mr. Clark is the Assistant Director of the Federal-Provincial Relations Division of the Department of Finance.

I have heard these other two gentlemen before, Doug, so I am particularly looking forward to your sharing with us the Canadian experience with RTS, as well as hearing from Bob and John about the RTS notions that we are dealing with here in this country.

Bob, you have some kind of time pressure, I am told, so we are going to let you go first, and we appreciate you being here.

TESTIMONY OF BOB HONTS, TRAVIS COUNTY COMMISSIONER, ON BEHALF OF THE TEXAS ACIR; JOHN SHANNON, ASSISTANT DIRECTOR, TAXATION AND FINANCE SECTION, ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, ACCOMPANIED BY ALBERT DAVIS, SENIOR ANALYST; AND DOUGLAS CLARK, ASSISTANT DIRECTOR, FEDERAL-PROVINCIAL RELATIONS DIVISION, CANADIAN DEPARTMENT OF FINANCE

Mr. HONTS. Mr. Chairman, thank you very much for giving us the opportunity to be here. My name, as you announced, is Bob Honts. I am here today on behalf of the Texas Advisory Commission on Intergovernmental Relations on which I am privileged to serve as chairman.

I am an elected county official in Travis County, Tex. I have been a member of the Texas ACIR since 1975. I am currently chairman of the Taxation and Finance Steering Committee of NACo, but I am not speaking today for NACo. They are here to represent themselves, and, as a matter of fact, I want to stress that my comments are on behalf of the Texas ACIR and its work. This commission was established by the Texas Legislature in 1971. Its purpose and membership are patterned after the national ACIR. The Texas commission is composed of State legislators, city, county, school, and special district representatives, as well as private citizens.

The Lieutenant Governor and the Speaker of the House serve as exofficio members.

During the commission's 11-year history, much of the work we have conducted falls in the area of State and local financial relationships and Federal, State, and local grant programs. We are obviously very interested and are following with great interest the current issues which involve general revenue sharing and other grant programs and the questions of the formulas that allocate those funds. These are activities that I suspect my NACo associates will support.

Obviously, reauthorization of general revenue sharing is NACo's top legislative priority in 1983. I testified on their behalf before the Senate Finance Committee to that effect. I would simply add here that local governments in Texas and around the country believe this is the most cost-effective grant program because of its flexibility and its low administrative cost.

While we are here to debate and discuss and, I hope, raise the different approaches to consider about general revenue sharing, we want to be sure that that discussion and debate don't, in fact, jeopardize the program itself. In the short term there are a number of actions that are necessary for reauthorization, and the timetable on which we are operating is limited.

Areas of consistent concern among counties in the country and in Texas are reduced employment, reductions in programs, postponement of capital improvements, and infrastructure expenses. Local governments have extremely limited alternatives for replacing lost Federal dollars and, I might add, limited alternatives for replacing State dollars that perhaps are not able to reach their level. Basically, then, the replacement of Federal revenues provided from the progressive income tax would need to be covered by local revenues primarily served by the ad valorem property tax. We don't need to discuss the problems with that tax, but there are many.

Perhaps the most important issue concerning reauthorization is the base level of funding. The current allocation has not kept up with inflation and thus represents significantly less purchasing power than a few years ago. It is appropriate that two of the bills under consideration this year do provide for annual increases and, I believe, make up some of the lost spending power from the past. Also, I am interested to note that the U.S. ACIR at its meeting last month, which I was able to attend and work with you there, reaffirmed its position that revenue sharing should be based on a constant percentage of the Federal personal income tax base and that the program should be funded through a permanent trust fund.

These are positions, I think, most county and city officials will support.

In terms of S. 700, it deserves a particular salute as the first major attempt to readdress the question of how the funds should be distributed. Noteworthy features are tying general revenue sharing to the income tax which, in fact, does deal with inflation, providing a substantial increase in total dollars, and including the States.

I would express a concern, however, about the proposed limitation of deductions of State and local taxes from the Federal income tax. Again, our main purpose today, as I understand it, is not that issue.

In terms of the formula, it is obvious that interstate and intrastate allocation issues are very sensitive. Each entity will fare either better or worse based on different allocation criteria.

It was difficult for Congress to establish the allocation procedures in 1972. For that reason, I am approaching—the Texas Advisory Commission is approaching—the formula question with caution and with concern. Perhaps it is appropriate that formula issues at least be considered after 10 years of operation. We are not sure, however, that we have sufficient information currently available on all of the range of options and the effects of those changes on the current pattern of distribution.

We have, on a preliminary basis, attempted to determine the impacts of S. 700 on interstate allocations. In fact, we have had that information available only recently, and we stress that our results are preliminary.

Now, speaking as chair of the Texas Advisory Commission and as a Texan, I will express a concern about the redistribution effects that may occur with the changes in Federal grant formulas. You are aware that Texas and some of the other States do not receive as much back from Federal aid programs as they pay in income taxes.

For example, the Tax Foundation recently reported that in 1981 Texas paid $1.46 in taxes for each dollar of Federal aid, which was a higher ratio than any other State. Actually, 22 States paid in more than they received back that year.

My point is that through the use of tax effort in the current revenue sharing and other grant formulas and other factors in those formulas, the allocation of funds among States and localities has been influenced dramatically. Officials in Texas and in other States receiving reduced amounts of Federal aid would be especially concerned how any proposed formula changes would affect them, and more important, how changes would affect their populations for whom the grants are designed to serve.

Under any approach, there will always be winners and losers, but there are three fundamental questions I would like to address. First, what are we really trying to accomplish with Federal aid formulas? Second, who are we trying to aid, a State, a series of States, cities or counties, or the U.S. citizens who, in fact, need the aid? Third, are the formulas constructed adequately to meet those functions as answered in questions 1 and 2?

Let's answer the three questions and see whether RTS tax effort, personal income as adjusted, or other formulas will best achieve those objectives. Question 1: What are we really trying to accomplish with Federal aid formulas? Regionalism aside, I hope the real answer is that the real purpose of Federal assistance is to assist persons in need.

Senator Humphrey from your State made a statment that:

> The real moral test of government is how it treats those who are in the dawn of life, the children; those that are in the twilight of life, the aged; those that are in the shadow of life, the sick and the needy, and the handicapped.

Nowhere in this famous quote do I read or hear that we are attempting to redistribute potential wealth between States except to meet the needs of the people who, in turn, need the assistance.

Question 2: Who are we trying to aid, a State, a city, a county, or U.S. citizens served by the same. The answer is obvious. We are trying to aid the citizens who need the help, not based on where they live, but based on their need. So in any State, the elderly, the unemployed, the homeless, the handicapped, the sick, the young, the poor, and the unskilled are the beneficiaries. And I submit to you that any and all of these in all 50 States should receive assistance based on their need to receive it and their own proof and demonstrated ability to provide it for themselves. This leads us to inclusion of some measure of need, if at all possible.

I submit that an elderly person or homeless person in Texas or Connecticut has just as much right to U.S. aid as a sick person in Ohio or Pennsylvania. But they haven't been getting it, and under the RTS system they won't get even as much as before—not because their need is less or their income or resources are greater, but because their State, under a formula that is developed, can potentially tax more than another State.

As a matter of fact, the RTS formula doesn't address the local governments within those States who may be denied access to some of the wealth or potential wealth that the formula would indicate is there. The fact that the Texas poor person is poor doesn't count, and RTS or tax effort does not measure need. Nor does it measure the philosophy or other constraints that may cause State leaders not to be willing or able to meet that person's need.

I submit to you that as Senators and Congressmen, we would hope that the Congress would address the needs of U.S. citizens, those that do need your help.

Let me give you an example of how past formulas sometimes intentionally, or perhaps by accident, can skew the ultimate result at the same time that it sounds that they are doing an appropriate job.

In the community development block grants, age of housing is included as part of the formula. The number of units built prior to 1940, for example, is not a question of substandard, inadequate, unsafe or unsanitary housing, but housing built before 1940. Now, I ask that some of it—my time is up, it says. If that's true, I haven't really covered it.

Senator DURENBERGER. OK. Your full statement will be made a part of the record.

Mr. HONTS. We will provide it. Senator, I didn't realize that we had that time constraint, and we will make it available to you.

Let me just close by saying that RTS has merit in some respects but does not, in our judgment, measure the need element. We would like to show, as well, that tax exportation is not a function totally of energy States. The best data available would indicate that nonenergy States are exporting, in fact, as many or more taxes to other States.

With that statement, let me, again, commend you on an attempt to readdress the formula question. Very frankly, I'm not satisfied particularly with personal income as adjusted or with tax effort, but the original numbers run by your RTS system provide some very interesting results. Perhaps we haven't interpreted the formula correctly, but the Texas Advisory Commission is looking forward to working with your staff if you will let us do that. We do have it now computerized and will attempt to continue to evaluate the effects. Perhaps we can make some suggestions that will improve your formula.

I commend you again for your effort.

Senator DURENBERGER. Thank you very much. It does seem a shame to ask you to come all the way from Texas and have a red light come on 10 minutes after you start talking, but we do that to Congressmen and Senators and everybody around here.

Mr. HONTS. Red lights in Texas mean different things. [Laughter.]

Senator DURENBERGER. Let me start out by addressing the citizen problem. You have already answered some of my questions which suggested that maybe you have misread at least some part of the RTS. I know you cannot stick around for John Shannon's testimony——

Mr. HONTS. I may be able to stay a while; I hope to as long as I can.

Senator **Durenberger.** All right.

As long as you quoted Hubert on morality and government, let me try to put some of what is proposed to be done here in perspective. There is much more to your statement than just what we sometimes call an energy-rich State complaining about redistribution formulas. There is much more to you, too. That is why I appreciate your being here and testifying.

But looking at it from the standpoint of your point about serving citizens and that very appropriate quotation from Senator Humphrey, two things occur to me: First, that things have changed since Senators Humphrey and Baker, at least on the Senate side, instituted the first revenue sharing program, and that we are now trying to look back with 12, 13, 14 years of experience and say, "That was great for a certain period of time." It may now have another function.

Second, and this came out forcefully in some of the testimony we had yesterday morning is that we are trying to put the whole issue of revenue sharing in a larger perspective of what needs to happen to this Federal relationship. It is not just a matter of how we reallocate funds between levels of government or how we change tax policy in one way or another.

One of the key elements is what we do about government's relationships with people and the whole income security issue. The first thing that the President started out with last year in his New Federalism proposal was determining our responsibility here at the national level and the State level and the local level to deal with the problems of people. That is an unresolved issue. We have talked "swaps" and AFDC and medicaid and things like that, but we haven't gotten anywhere. We all can agree that the present system is badly flawed, but getting a consensus on how to improve it is something else again. And while I am on this subject, let me clarify a possible misunderstanding that might arise from your statement. Probably the biggest reason Federal aid is less in Texas than in Minnesota is the fact that the large income security matching programs—AFDC, medicaid and the like—depend upon how generous the State programs are. Texas chooses quite modest programs that in turn generate considerably less Federal assistance. But this is Texas' choice.

If we are going to do something good for people in this whole New Federalism process, we have got to get at health care. We have got to get at the issue of medicaid. We have got to get at the problems of some of those big Texas hospitals—like the large Cherry Hospital in Houston, that was in testifying before when we were doing medicare—incredible costs that fall on the city and county institutions that must care for the indigent when they fall through the cracks of the Federal system.

Whether you are talking about health care for unemployed persons or health care for the structually unemployed or health care for the poor or the aged, whatever, that is a tough question for you at the county level and a tough question for Governors and legislators—the basic cash programs, housing, food stamps, and the nutrition program. We just have to deal with that in some way. The way we are not going to deal with it is take all those programs over and run them out of Washington. Obviously, it is going to be done differently.

One of the ways to enable us to do it differently is to recognize the different capacity that different States have to raise their own money to help solve some of these problems. That really is the thesis or the theory behind my personal endorsement of the representative tax system. As I read through the report of the Texas ACIR, that you represent, it looked to me as though you were asserting that the representative tax system rewards high tax effort in some way.

Is that correct? And before you answer, let me state that the Texas ACIR report to which I refer will be made part of the record. Go ahead.[1]

Mr. **Honts**. Let me say that in our meeting in Charleston and with my following reviews with your staffs we had not seen S. 700. We were reading and reviewing the RTS and tax effort in a different context.

The current revenue sharing formula, in effect, has a major element on tax effort, which is replaced by RTS in S. 700. I commend you for that, and as a matter of fact, it does very interesting things to the winners and losers. I do not know if you all have run those numbers. We have made our first attempt by computer formula to do that. While Texas would, perhaps, fare better with some other formula element, it fares better with this than it would with tax effort under the current formula.

I might mention that your bill provides a lot more money, so everybody is a winner. But the losers in Texas would be the local governments, because you are splitting the money between local governments and the State. Now the State does not receive any funds and that is the entity that you all say, under your formula, is supposedly the one with all this potential wealth and not the cities and the counties. So the losers are the cities and counties and the people they serve in terms of direct passthrough, such as spending for mental health, for rape-crisis help and other essential purposes. The potential wealth at the State level does not necessarily transfer to the local level guy in the Rio Grande Valley who is in desperate need of somebody's help.

The second thing to say is that removing the tax effort element is very appropriate, and it is one of the best things about S. 700 because tax effort does reward, to some extent, those entities that tax a lot, and spend a lot. There is a judgment call on whether they need to do that in the first place, so that is a great big step forward.

RTS, however, measures potential wealth, and we think that it needs some improvement. It is a good element. It probably should be one formula element, but perhaps not the only. Should need be measured, too. If there is some improvement by including need along with RTS, it might make a big difference. California and New York, for example, would have much more under this formula that you are proposing than they would under the other revenue sharing proposal.

Senator **Durenberger**. That is a little-known fact that John Shannon will bring out in his testimony, and it is probably clouded by the fact that when I go around giving my speech on fiscal disparities, I illustrate disparities using Mississippi and Texas, which may give people the wrong impression—like whoever wrote the article in Texas Monthly entitled "Tax Fraud." I hope you go back and convince him that he is wrong.

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[1] See p. 183.

But I probably bring a lot of this on myself.

Mr. Honts. I have never been able to tell Texas journalists if they were wrong.

Senator Durenberger. I do not want him to admit he was wrong; I just want him to write a second article.

I think your response indicates that one of the things we are trying to work on here in keeping a two part formula is that we recognize the reality of some of the differences in capacity at the local level. So there are differences among the States in terms of using a strict capacity at the State level versus the local level.

I think we are trying to resist compensating for that with more Federal programs. We are trying to move that responsibility, if you will, back closer to State and local government. But if we keep revenue sharing one side local with its kind of a formula that reflects its differences and the other side state with its formula, perhaps we can approach a solution to the problem. I am pleased that you are willing to work with all of us. We did not invent RTS. ACIR claims to have, but I am sure that it was sort of a collective process that a lot of people put together. We had some comments yesterday about the fact that we are not precise enough in S. 700 about exactly how you go about doing it, but we also heard from the General Accounting Office that if we tried to get any more precise, we would probably goof it up; that we probably had done a pretty good job in putting together how that process ought to work.

So right now it seems to me that this hearing and the informal meetings that we have, constitute a very important process. The important thing is that people like you in States like yours help all the rest of us—us Northeast-Midwest, snow belt types—understand better how we can design a formula that goes, let us say, beyond the old effort and need formulas into one that gets you back to Hubert Humphrey's ideals.

I will hold you and probably a lot of other Texans to that quotation. Since you have used it, I will keep dragging it back from time to time.

Mr. Honts. If you can find the appropriate way to measure needs for individuals that ought to receive the aid, that is exactly what we are trying to say. And let me say again that if a State, any State, has a legislature with leaders that do not address a problem appropriately in the eye of the Congress or the Federal Government and if, in effect, what the Federal Government says is you are not only punished for that; we take money away from you and from the Federal Treasury as well because of that State action. It is a double whammy which will, in fact, to the person on the street, make very little difference.

The theory is that you will apply pressure on that State capital. As a matter of fact, this formula would reward that State capital. It would give them money they do not have today, taking it away from cities and counties and from those needy people.

I suggest that the formula might allocate money by State and then decide whether it goes to local governments or the State government based on potential wealth or measures of potential wealth of a city or county. In the State of Texas, for example, it could be determined on the basis of property taxes and the tax resources that they have been able to award on that basis at the local level.

Senator **Durenberger.** Thank you very much, Bob. We will go on. Whatever your time problem is——

Mr. **Honts.** I will stay as long as I can.

Senator **Durenberger.** I will leave that to you.

We will go to John Shannon. John, thank you very much for being here. We will make your printed statement a part of the record. You may proceed as you wish.

Excuse me.

Carl, do you have an opening statement?

Senator **Levin.** I will wait for Mr. Shannon to testify.

Senator **Durenberger.** Go ahead, John.

Mr. **Shannon.** Thank you, Mr. Chairman. Before giving my testimony, I would like to introduce my associate, Mr. Albert Davis, senior analyst on the staff of the ACIR.

We appreciate. Mr. Chairman, this opportunity to both present the commission's position on revenue sharing and to respond to your request for a description of the representative tax system as a means of measuring the tax capacity or the tax wealth of the States.

On the issue of general revenue sharing, the ACIR has a long and official record of support. At its recent meeting in Charleston, S.C., the commission reaffirmed that support with an endorsement that reads as follows:

> Over the two decades, the Advisory Commission on Intergovernmental Relations has consistently supported the general revenue sharing concept and has endorsed three principles to govern the operation of the program. To ensure adequate intergovernmental coverage, the Commission has recommended that States as well as local governments be made direct program beneficiaries. To ensure program certainty, the Commission has urged the use of a permanent trust fund as the funding mechanism.
>
> To ensure funding adequacy and growth, the Commission has called for the sharing of a constant percentage of the Federal income tax base.

The point must be emphasized, however, that the Commission did not recommend, at its Charleston meeting, any basic changes in the formula for distributing the GRS funds. However, many persons have been interested in formula changes, and they have suggested, among other things, a switch from the current per capita income measure to the representative tax system approach estimating the tax wealth of the States.

Mr. Chairman, I would like to make a few brief observations that are intended to explain both the RTS concept and respond to certain charges leveled against it by its critics.

First, the representation system is a rather sophisticated yardstick for measuring the relative tax capacity of each of the 50 State-local systems. It answers the question: How would each of the 50 States rank on a tax productivity scale if every State applied identical rates—national averages—to each of the 26 commonly used bases?

In our appendix A, we take you through a step by step description of the technique used.[1]

Second, the representative tax system yardstick was created because the present measure used by the Congress per capita income, has three serious shortcomings.

These shortcomings can be summarized as follows: the per capita income measure significantly understates the real tax wealth of energy-rich as well as tourist-rich States, and it overstates the tax wealth of several Frost Belt States confronted with declining economic bases. We present in table 1 on page 4 of our prepared statement the extreme cases of over and under statement.[1]

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[1] See p. 144.

My third observation deals with the fact that the representative tax system has, in our judgment, been unjustly criticized as being biased in favor of the big spending States. Notwithstanding these dogged assertions, the representative tax system approach does not discriminate in favor of heavy taxing States and against light taxing States.

The relative tax capacity rating for each State in our Union does not depend on its particular taste for public goods and services. Moreover, the tax capacity index for each State would be identical whether all of the representative tax rates that are used in our calculations were twice as high or whether they were cut in half.

It is the tax effort factor in the general revenue sharing formula, not the tax capacity measure, that works clearly in favor of heavy spending States such as New York. For example, if the tax effort factors were stripped out of the present GRS formula completely and the RTS measure substituted for the present per capita income measure, the relatively light spending State of Texas would receive an additional $10 million in GRS funds while the heavy spending State of New York would have its 1983 GRS allotment cut by approximately $90 million.

So, again, it is the tax effort factor and not the capacity measure that drives the money around.

Fourth, some of those who oppose the introduction of the representative tax system claim that its utilization should wait until there is a comparable breakthrough on the expenditure side of the fiscal equation to insure that both revenue capacity and expenditure needs are adequately weighed.

Unfortunately, this counsel of perfection is also the counsel of interminable delay. It is difficult enough to measure State revenue capacity, it is virtually impossible to get widespread agreement on what constitutes legitimate expenditure needs.

Fifth, the representative tax system approach has been criticized as being too complex. There is no question, Mr. Chairman, but that the RTS yardstick is far more complicated than the per capita income measure. There is, however, the obvious rejoinder. For every complex problem there is an answer that is neat, simple and wrong. The very neat and the very simple per capita income measure produces very wrong answers for many of the energy-rich States, for some of the tourist States and for several of the Frost Belt States.

Sixth, although the RTS has some data imperfections, it still stands out as a far more accurate yardstick of State tax capacity than does the per capita income measure. There is no question that the RTS has certain data problems, the most important being the lack of annual property tax valuations.

Nevertheless, on a score of 1 to 100, I would score the accuracy of the RTS measurement at least 90 and the per capita income measure at no more than 70. In my judgment, Mr. Chairman, a B+ performance should be favored over a D− performance every day of the week.

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[1] See p. 140.

I thank you for giving us this opportunity.

Senator DURENBERGER. Thank you, John.

You heard the testimony of Bob Honts and our conversation concerning the interpretation of RTS. Do you have anything you want to add to that?

Mr. SHANNON. No. I just, again, want to underscore the fact that it is tax effort and not fiscal capacity that tills Federal funds toward or away from the light spending States.

Senator DURENBERGER. I want to ask you a question about another common misunderstanding about RTS, and that concerns the application of average tax rates to each State's tax base in order to get the relative capacity index. Some people say that this imposes on States a Federal conviction that they should tax at an average rate and somehow disadvantages States that choose to tax below that. It seems to me all the RTS does is standardize different tax bases like the number of cigarettes that get sold in a State or the number of gallons of gasoline that are sold or alcohol or hunting licenses or fishing licenses, or you name it, so that you have got a standard base to make a comparison.

It really seems that it would make no difference in the relative ranking of the States by the RTS index if it chose the lowest rates, the highest rates, as long as the same rates were chosen to make these comparisons; is that correct?

Mr. SHANNON. That is correct. We are applying a standardized system, and Mr. Clark will be describing this same system as it operates in the Canadian system.

Senator DURENBERGER. Let me, for the record, ask you in a little bit of detail regarding the interstate formula contained in S. 700. Isn't it true that taking the two factors in the formula, population and fiscal capacity, they do not determine how redistributive the formula is?

Mr. SHANNON. I agree.

Senator DURENBERGER. There is another parameter in the formula—that is a constant—that must be set in order to determine how much Mississippi per capita's allotment is going to be compared to Texas'; is that correct?

Mr. SHANNON. Yes, that is correct.

Senator DURENBERGER. So if Texas wanted to argue with Mississippi over how redistributive the program should be, the question of the RTS is irrelevant to that particular argument.

Mr. SHANNON. It is irrelevant, yes.

Senator DURENBERGER. They need to argue over what value is finally given to this constant in the formula or perhaps over the possible minimum allotments that would override the formula; is that a fair statement?

Mr. SHANNON. That is correct, Mr. Chairman.

Senator DURENBERGER. So in summing up, is it fair to say that much of the controversy surrounding the RTS results from the fact that we have adopted formulas in the past without much understanding as to what those formulas actually do and without understanding exactly how equalizing their mathematical formula makes them?

Mr. SHANNON. That is correct. The various factors that have been built into the system tend to create a very confusing conception of just what factors are driving dollars through the system.

Senator DURENBERGER. As a final point, would you elaborate a little bit on the question of including expenditure needs into the GRS formula? What are the problems in doing that, both technical problems and perhaps conceptual problems?

Mr. SHANNON. Historically, the Congress has used very narrow definitions of aids, and our elaborate categorical aid system was built to reflect our concern for roads, or for baby clinics, or airports. Specific needs were identified and the Congress assisted in the funding of those specific State and local program needs.

But to move to a generalized concept of expenditure requirements is very, very difficult, and it is extremely difficult in a highly heterogeneous Federal system to get agreement between people in Texas and the people in New York and the people in Washington State as to what should constitute a basic bundle of services.

The chances of getting that type of agreement are much better in a homogeneous society, but in our diverse, fragmented, or pluralistic society, it would be an uphill fight to try to get general agreement as to what should be the basic bundle of services throughout this Nation.

Mr. Chairman, my associate, Al Davis, has done a lot of thinking on this subject, and he might like to elaborate on it.

Senator DURENBERGER. Al, do you have an observation you would like to share with us on that subject?

Mr. DAVIS. One implication of what John said about our history of many programs for particular needs is that one can argue for a division of labor among grants. Problems of needs could be thrashed out, as we do now, in the AFDC formula, medicaid formula, highway aid program, and so on. Problems of fiscal capacity and fiscal disparities can be addressed in the revenue sharing program.

One thing is clear: As a whole, the current grant system does not favor the poorer States. In fact, it favors the richer States. Accordingly, there is a need to give attention on the capacity side, and revenue sharing formulas are a place to do so.

It is possible to move to a generalized measure of need in the revenue sharing program. The Australians have done it, but as John has suggested, there are many factors that make that politically easier in Australia than it would be here. Australian society is more homogeneous; there is a parliamentary system; they use a well respected grant commission and, apparently, have a national commitment to redistribution among States.

To move to a comprehensive needs measure in this country would raise a number of specific issues. One is an issue of public philosophy. We do have strong differences of opinion in this part of the country as to what is the role of the public sector and whether it should respond to a particular problem or not. Is old housing a public problem, or is it not a public problem? We have disagreements about that.

We would have difficult conceptual issues to resolve. For example, is a State that has always been relatively poor in economic activity needier than a State which is suffering an economic decline? Is it the static situation or the dynamic situation? If we got past those issues, then we have to measure whatever it is that we are really interested in. There are a lot of problems in getting the data on those types of things that we would all like to recognize. One example of a difficult issue is that of differences among costs of living and costs of government. How would you account for that?

Finally, we have the measurements. We have to figure out how to combine them all in a formula. Do we take all these relative indicators and multiply them all together, or add them up, or divide them by a square root, or so on and so on. So general needs measurement would be quite an ambitious undertaking, though not a conceptually impossible one.

Senator DURENBERGER. Thank you.

Senator Levin?

Senator LEVIN. Thank you, Mr. Chairman.

Let me pose a few questions.

Mr. Shannon, I gather that Congressman Horton suggested that we approach this problem by making it optional, that the reauthorizing legislation should permit the States to use either the per capita income or the RTS to determine its allocation.

Have you considered that?

Mr. SHANNON. Our commission has not actually addressed it, so I will just give you my own views on the subject. In fact, we were asked by Chairman Weiss to cost out that type of compromise.

Senator LEVIN. That was my next question, sir.

You are way ahead of me.

Mr. SHANNON. According to our calculations, it would add about 4.5 percent to the total cost of the GRS program to do it along the lines that you suggest.

Senator LEVIN. In dollars, what would that be?

Mr. SHANNON. On a program that is approaching $5 billion, that would be about $200 million additional cost to the program.

Senator LEVIN. How many——

Mr. SHANNON. $200 to $250 million.

Senator LEVIN. Thank you.

How many winners and losers are there under your approach?

How many States gain and how many lose? I see your list attached to your testimony, but I haven't had a chance to add them.

Mr. SHANNON. We would have to run the formula right through for you to give you that precise answer.

On page 4, of course, we are only giving you the most extreme case examples. In appendix C, we do give you the per capita tax capacity numbers, but we would have to run through a formula to supply that information. We would be glad to do it.

Senator LEVIN. Could you do that? Could he provide that for the record, Mr. Chairman?

Mr. SHANNON. Sure.

Senator LEVIN. Could you, for each State, tell us the amount they would come out ahead or behind, using the present level of funding?

Mr. SHANNON. Oh, using the present level of funding?

All right.

Senator LEVIN. Well, whatever level you want. If you have a better level than that, it is OK, too.

Mr. **Shannon**. The plan that we looked at originally would have left—no State would have been hurt, but the States that would have been advantaged by using RTS would swing into the RTS column, and that would add roughly 4.5 percent to the total cost of the program.

Senator **Levin**. That is if you make it optional.

Mr. **Shannon**. Yes.

Senator **Levin**. But if you don't, if you lose the same size pie and there are winners and losers, then the question is: How many winners, how many losers, and how much for each?

Mr. **Shannon**. We will supply that information.

Senator **Levin**. Will you also supply that other study you made showing there is a 4.5 percent increase in the cost if you have an optional approach?

Mr. **Shannon**. Yes. Right.

[The information referred to follows:]

ADVISORY
COMMISSION ON INTERGOVERNMENTAL RELATIONS
WASHINGTON, D.C. 20575

April 11, 1983

The Honorable David Durenberger
Chairman, Subcommittee on Intergovernmental
  Relations
U.S. Senate
517 Carroll Arms
301 First Street, N.E.
Washington, D.C. 20510

Dear Chairman Durenberger,

I am replying to a request by Senator Levin for further information. This request was made at your April 6, 1983 hearing on revenue sharing. Let me break down the request into two questions:

1. What would be the state-by-state effects and added cost if revenue sharing allocations were determined by granting each state area whichever allocation were greater: one based on resident per capita income (the conventional method) or one based on the "Representative Tax System" (RTS)?
2. What would be the state-by-state effects if revenue sharing allocations were again determined by initially granting each state area whichever allocation were greater (one based on resident per capita income or one based on the "Representative Tax System"), but no additional funding were provided?

Questions and Answers

1. What would be the state-by-state effects and added cost if revenue sharing allocations were determined by granting each state area whichever allocation were greater: one based on resident per capita income (the conventional method) or one based on the "Representative Tax System" (RTS)?

The purpose of adding funds is to prevent any state area from losing revenue sharing dollars, while allowing those that would benefit from the RTS measurement to gain. We estimate that in 1983, such a plan would benefit seventeen state areas.

Based on our simulation of 1983 revenue sharing allocations, we estimate that the added cost of this RTS option would be 4.5% of whatever amount would otherwise be appropriated under current law. At a $4.57 billion dollar level, the added cost is $207 million. At a $6.83 billion level, as prevailed in 1980, the add-on would be $307 million.

Because of our limited ability to keep up with the most current revenue sharing data elements, and limited computer precision, we cannot precisely replicate Office of Revenue Sharing results. Nevertheless, we enclose the results of our simulation as Attachment A. It gives a rough idea of which states would, in 1983, have been helped and by how much. Of course, results can change from year to year.

The "alternative GRS" simulation was done by substituting RTS measurements for income measurements whenever they were components of either "general tax effort" or "relative income level." No change was made for the one part of the five factor formula dealing with "income tax effort." Only measurement changes were made; no changes were made to the mathematical GRS formulae. If measurement changes were to be made in combination with formula changes, the simulation results would be different.

2. What would be the state-by-state effects if revenue sharing allocations were again determined by initially granting each state area whichever allocation were greater (one based on resident per capita income or one based on the "Representative Tax System"), but no additional funding were provided?

As with the first simulation, each state was initially awarded the greater of the current or alternative amount, but since the sum of the initial results exceeded the current $4.567 billion appropriation, the final grant amount for each state became a lower prorata fraction of the initial result. Attachment B shows our results. The same caveats on accuracy apply as for the first attachment.

Because no extra funding was used in the alternative GRS simulation, there are losing as well as gaining state areas. Nine states gain and forty-two lose. Again, if changes were to be made to the mathematical formulae, as well as in measurements, the results would be different.

I hope that these answers are helpful and we are ready to provide more explanation, if necessary.

Sincerely,

John Shannon

John Shannon
Assistant Director

Enclosures

EXHIBIT A: RESULTS APPROXIMATE CONDITIONS GOVERNING THE 1983 DISTRIBUTION

STATE	Regular GRS	Alternative GRS Using RTS Capacity and Effort	Greater of Regular or Alternative GRS	Result on a Per Capita Basis	Change	
	($ in thousands)		($ thousands)		Percent Increase	Increase Per Capita
Alabama	$79,069	$78,322	$79,069	$20.19		
Alaska	$36,960	$16,029	$36,960	$89.71		
Arizona	$55,051	$65,699	$65,699	$23.51	19.3%	$3.81
Arkansas	$46,025	$44,146	$46,025	$20.05		
California	$510,880	$499,836	$510,880	$21.11		
Colorado	$51,801	$50,631	$51,801	$17.47		
Connecticut	$54,096	$54,620	$54,620	$17.43	1.0%	$0.17
Delaware	$13,415	$12,863	$13,415	$22.43		
Washington D.C.	$18,391	$18,338	$18,391	$29.15		
Florida	$164,113	$159,051	$164,113	$16.12		
Georgia	$110,993	$116,176	$116,176	$20.84	4.7%	$0.93
Hawaii	$22,477	$22,178	$22,477	$22.91		
Idaho	$18,556	$17,193	$18,556	$19.35		
Illinois	$215,046	$214,183	$215,046	$18.76		
Indiana	$85,383	$88,715	$88,715	$16.22	3.9%	$0.61
Iowa	$54,385	$47,773	$54,385	$18.76		
Kansas	$39,283	$36,534	$39,283	$16.48		
Kentucky	$76,395	$69,448	$76,395	$20.86		
Louisiana	$93,439	$60,996	$93,439	$21.69		
Maine	$28,204	$27,953	$28,204	$24.89		
Maryland	$87,722	$89,650	$89,650	$21.03	2.2%	$0.45
Massachusetts	$137,076	$143,396	$143,396	$24.84	4.6%	$1.09
Michigan	$175,318	$194,872	$194,872	$21.17	11.2%	$2.12
Minnesota	$84,533	$83,710	$84,533	$20.65		
Mississippi	$63,603	$62,614	$63,603	$25.13		
Missouri	$78,729	$78,403	$78,729	$15.93		
Montana	$18,708	$11,948	$18,708	$23.59		
Nebraska	$28,493	$29,579	$29,579	$18.76	3.8%	$0.69
Nevada	$13,850	$12,121	$13,850	$16.39		
New Hampshire	$14,085	$12,924	$14,085	$15.05		
New Jersey	$144,292	$146,572	$146,572	$19.80	1.6%	$0.31
New Mexico	$36,750	$18,306	$36,750	$27.67		
New York	$464,469	$581,007	$581,007	$33.01	25.1%	$6.62
North Carolina	$120,656	$128,908	$128,908	$21.65	6.8%	$1.39
North Dakota	$13,924	$8,581	$13,924	$21.16		
Ohio	$172,828	$172,505	$172,828	$16.03		
Oklahoma	$60,333	$46,363	$60,333	$19.46		
Oregon	$54,323	$52,502	$54,323	$20.49		
Pennsylvania	$221,315	$236,408	$236,408	$19.91	6.8%	$1.27
Rhode Island	$19,574	$24,871	$24,871	$26.10	27.1%	$5.56
South Carolina	$69,301	$71,453	$71,453	$22.56	3.1%	$0.68
South Dakota	$15,788	$11,917	$15,788	$23.02		
Tennessee	$85,690	$87,329	$87,329	$18.94	1.9%	$0.36
Texas	$248,585	$210,444	$248,585	$16.84		
Utah	$34,578	$31,735	$34,578	$22.78		
Vermont	$12,696	$11,304	$12,696	$24.61		
Virginia	$98,510	$98,424	$98,510	$18.14		
Washington	$66,893	$68,220	$68,220	$16.18	2.0%	$0.31
West Virginia	$41,106	$30,385	$41,106	$21.06		
Wisconsin	$97,361	$103,461	$103,461	$21.82	6.3%	$1.29
Wyoming	$11,642	$6,105	$11,642	$23.66		
TOTAL	$4,566,699	$4,566,705	$4,773,951	$20.82	4.5%	$0.90

ADDED COST OF AWARDING GREATER OF ALTERNATIVE OR REGULAR GRS IS $207,252 ($ THOUSANDS)

*NOTE: Regular GRS uses 1981 population, 1980 urbanized population, 1979 per capita money income, FY81 state taxes, CY80 aggregate personal incomes, CY81 state and federal income tax collections. The alternative uses the same populations and state and federal income tax data, and 1980 representative tax system measures of tax capacity and effort.

Source: ACIR staff, April 11, 1983.

ATTACHMENT B: RESULTS APPROXIMATE CONDITIONS GOVERNING THE 1983 DISTRIBUTION*

STATE	Regular GRS	Alternative GRS Using RTS Capacity and Effort	Pro-rated Greater of Regular or Alternative GRS	Result on a Per Capita Basis	Change Percent Change	Change Change Per Capita
	($ in thousands)		($ thousands)			
Alabama	$79,069	$78,322	$75,636	$19.31	-4.3%	-$0.88
Alaska	$36,960	$16,029	$35,356	$85.82	-4.3%	-$3.89
Arizona	$55,051	$65,699	$62,846	$22.49	14.2%	$2.79
Arkansas	$46,025	$44,146	$44,027	$19.18	-4.3%	-$0.87
California	$510,880	$499,836	$488,702	$20.20	-4.3%	-$0.92
Colorado	$51,801	$50,631	$49,552	$16.71	-4.3%	-$0.76
Connecticut	$54,096	$54,620	$52,249	$16.67	-3.4%	-$0.59
Delaware	$13,415	$12,863	$12,833	$21.46	-4.3%	-$0.97
Washington D.C.	$18,391	$18,338	$17,592	$27.88	-4.3%	-$1.27
Florida	$164,113	$159,051	$156,988	$15.42	-4.3%	-$0.70
Georgia	$110,993	$116,176	$111,132	$19.94	0.1%	$0.02
Hawaii	$22,477	$22,178	$21,501	$21.92	-4.3%	-$0.99
Idaho	$18,556	$17,193	$17,750	$18.51	-4.3%	-$0.84
Illinois	$215,046	$214,183	$205,710	$17.95	-4.3%	-$0.81
Indiana	$85,383	$88,715	$84,863	$15.52	-0.6%	-$0.10
Iowa	$54,385	$47,773	$52,024	$17.95	-4.3%	-$0.81
Kansas	$39,283	$36,534	$37,577	$15.77	-4.3%	-$0.72
Kentucky	$76,395	$69,448	$73,079	$19.96	-4.3%	-$0.91
Louisiana	$93,439	$60,996	$89,382	$20.75	-4.3%	-$0.94
Maine	$28,204	$27,953	$26,979	$23.81	-4.3%	-$1.08
Maryland	$87,722	$89,650	$85,758	$20.12	-2.2%	-$0.46
Massachusetts	$137,076	$143,396	$137,170	$23.76	0.1%	$0.02
Michigan	$175,318	$194,872	$186,412	$20.25	6.3%	$1.21
Minnesota	$84,533	$83,710	$80,864	$19.75	-4.3%	-$0.90
Mississippi	$63,603	$62,614	$60,842	$24.04	-4.3%	-$1.09
Missouri	$78,729	$78,403	$75,311	$15.24	-4.3%	-$0.69
Montana	$18,708	$11,948	$17,896	$22.57	-4.3%	-$1.02
Nebraska	$28,493	$29,579	$28,295	$17.94	-0.7%	-$0.13
Nevada	$13,850	$12,121	$13,249	$15.68	-4.3%	-$0.71
New Hampshire	$14,085	$12,924	$13,474	$14.40	-4.3%	-$0.65
New Jersey	$144,292	$146,572	$140,209	$18.94	-2.8%	-$0.55
New Mexico	$36,750	$18,306	$35,155	$26.47	-4.3%	-$1.20
New York	$464,469	$581,007	$555,784	$31.58	19.7%	$5.19
North Carolina	$120,656	$128,906	$123,312	$20.71	2.2%	$0.45
North Dakota	$13,924	$8,581	$13,319	$20.24	-4.3%	-$0.92
Ohio	$172,828	$172,505	$165,325	$15.33	-4.3%	-$0.70
Oklahoma	$60,333	$46,363	$57,714	$18.62	-4.3%	-$0.84
Oregon	$54,323	$52,502	$51,965	$19.60	-4.3%	-$0.89
Pennsylvania	$221,315	$236,408	$226,144	$19.05	2.2%	$0.41
Rhode Island	$19,574	$24,871	$23,791	$24.96	21.5%	$4.43
South Carolina	$69,301	$71,453	$68,351	$21.58	-1.4%	-$0.30
South Dakota	$15,788	$11,917	$15,102	$22.02	-4.3%	-$1.00
Tennessee	$85,690	$87,329	$83,538	$18.11	-2.5%	-$0.47
Texas	$248,585	$210,444	$237,793	$16.10	-4.3%	-$0.73
Utah	$34,578	$31,735	$33,077	$21.79	-4.3%	-$0.99
Vermont	$12,696	$11,304	$12,145	$23.54	-4.3%	-$1.07
Virginia	$98,510	$98,424	$94,233	$17.35	-4.3%	-$0.79
Washington	$66,893	$68,220	$65,259	$15.48	-2.4%	-$0.39
West Virginia	$41,106	$30,385	$39,321	$20.14	-4.3%	-$0.91
Wisconsin	$97,361	$103,461	$98,970	$20.87	1.7%	$0.34
Wyoming	$11,642	$6,105	$11,136	$22.64	-4.3%	-$1.03
TOTAL	$4,566,699	$4,566,705	$4,566,697	$19.91	0.0%	0.00

*NOTE: Regular GRS uses 1981 population, 1980 urbanized population, 1979 per capita money income, FY81 state taxes, CY80 aggregate personal incomes, CY81 state and federal income tax collections. The alternative uses the same populations and state and federal income tax data, and 1980 representative tax system measures of tax capacity and effort.

Source: ACIR staff. April 11, 1983.

Senator **Levin**. Of course, one of my major concerns is which of these factors best and most equitably addresses the problem of high unemployment and the declining tax base. This is particularly important where the tax rates are just as high as they have always been, but the yields are down because of high unemployment or a declining tax base, or in some cases, down relative to other areas, and as a result, there is a loss of revenue sharing.

This is a major concern in the State I happen to represent. We have communities which have lost revenue sharing money through no fault of their own. I don't think it was the purpose of revenue sharing to punish communities who don't change their tax base but who, through unemployment, have seen their yields reduced.

I am wondering which formula would be most sensitive to that problem and would result in less harsh shifts as a result of high unemployment.

Mr. **Shannon**. The RTS approach is much more sensitive to these changes. The reason why is because when the economy of a State turns stagnant or declines, its sales volume and its property values do not hold up as well as personal income.

Consequently, if we rely solely on per capita income, we are bound to overestimate the tax capacity of States in poor economic health.

Income is a lagging indicator of tax wealth, whereas property values and sales transactions tend to be more current. So by using RTS we catch the States that are in a decline more rapidly than we do by using a per capita income measure.

Senator **Levin**. Thank you, Mr. Chairman.

Senator **Durenberger**. Thank you very much, John.

Our next witness is Douglas Clark.

I notice in his statement he was a disclaimer, so the Justice Department doesn't have to—[laughter]—slap one on him. You don't represent the Film Board here, anyway, Doug, so you don't have to worry. We appreciate your being here and presenting your testimony.

Senator **Levin**. Can he be filmed, though?

What if they have a disclaimer? [Laughter.]

Mr. **Clark**. Mr. Chairman and members of the Senate Subcommittee on Intergovernmental Relations, it is an honor and a privilege for me to comply with your request to provide information on the use and operation of the representative tax system in Canada.

Any reference before an American audience to the use of the RTS in Canada should begin by acknowledging our debt to the ACIR. Indeed, the ACIR may be said to have invented this system back in 1962 with the publication of its landmark document entitled "Measures of State and Local Fiscal Capacity and Tax Efforts", following work by a group of well-known American economists which included Ecker-Racz, Mushkin, Manvel, Peckman, and Shoup. We in Canada moved rather quickly to import this product of Yankee ingenuity—taking full advantage of the absence of any patent royalties, copyright royalties, trademark fees, export charges, import tariffs, or other barriers to trade. This was done back in 1967 when the RTS was introduced into an existing Fiscal Equalization Program which had been in place since 1957. By 1986, when present legislation governing equalization expires, the RTS will have been in operation for 20 years.

The principal portion of what I have to say concerns the use of the RTS in the Fiscal Equalization Program. However, I should note that we use it for other purposes as well.

First, we use it to construct indices of fiscal capacity and tax effort which are important analytical tools in any fiscal comparison of provinces. Second, last year we built the RTS into a long-term revenue sharing agreement between Canada and Nova Scotia, pursuant to which Canada will share specified revenues from offshore resources situated in a zone adjacent to Nova Scotia, with the extent of such sharing depending upon that Province's level of fiscal capacity. Other uses for the RTS are likely to be found in the future.

Let me now turn to the Fiscal Equalization Program. This is a major Federal program that involves annual, unconditional payments to provinces. These payments are presently running at a level of $5 billion and constitute almost 6 percent of total Federal expenditures. The purpose of equalization, as set out in the Constitution of Canada, is "to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."

Accordingly, payments are made to those provinces that are unable, from their own resources, to finance some reasonable level of public services. Although equalization payments are made to provincial governments, they take account of the collective capacities and needs of local governments in each province as well, it being assumed that payments to a province will inevitably benefit its local governments and that a province together with its local governments constitute a single fisc.

In determining provincial entitlements to equalization, we have always made the implicit assumption that each Canadian province can provide the overall level of public services with which equalization is concerned at the same per capita cost. This undoubtedly is an oversimplification and is a matter to which I will return later. There is, however, general agreement in Canada that intergovernmental disparities in provincial public finance arise mainly on the revenue side of the ledger and, accordingly, the key issue to be addressed is how to compare provinces in their relative capacities to derive revenues from taxation and other sources under their control.

The RTS is not the only means by which provinces can be compared in respect of fiscal capacity. There are two basic ways in which the revenue-raising capacities of provinces can be compared. These are by means of a "macro" approach and a "micro" approach.

The micro approach, of course, is the RTS. Where a macro approach is used, one would search for some broad single measure, or perhaps two measures, of income of or value of production out of which all taxes may be said to be paid. Such an approach would have some advantages over an RTS, which are referred to in my full text. I will not go into them verbally, because we have not, so far, found them to be important in Canada.

I would add, too, that any macro measure of fiscal capacity would need to be considerably more sophisticated than personal income.

Although some macro measures of fiscal capacity are available and do have certain advantages, there is a strong consensus among governments that these advantages are considerably outweighed by the disadvantages.

The most fundamental disadvantage of a macro measure of fiscal capacity is that it does not relate to the real world of what provincial or state governments actually tax but, rather, to what they potentially have available to tax. Thus, in the real world, provincial governments obtain large revenues from oil and gas but not from iron and coal; from alcoholic beverages but not from Coca Cola; from tobacco and lotteries but not from candy and television; from gasoline but not from electricity; from real property but not from personal property.

The RTS recognizes these differences because it determines fiscal capacity by taking account of the actual taxing practices of provinces and local governments. These practices are designed to capture economic rents wherever they exist and to take advantage of the spending priorities of society by taxing most heavily those goods and services for which there is a relatively inelastic demand. Since macro concepts of fiscal capacity do not recognize these distinctions, they neglect the uneven provincial distribution of many of the things that are taxed heavily and do not provide a sensitive measure of fiscal capacity.

The advantage of the RTS can be stated in another way: the RTS provides a direct measure of the fiscal capacity of governments, whereas alternative measures of capacity relate to people or to the economy as a whole. These alternatives are useful for many purposes, but it must be questioned whether they are appropriate for determining the amount of transfer payments that go to governments.

The Canadian RTS has been designed to take account of whatever elements of income, consumption, wealth or economic rents are taxed by the provinces. It does this by taking account of virtually all revenues from own sources that are derived by any of the 10 provinces, including their local governments.

These provincial-local revenues are classified into separate categories for each type of tax, or group of related taxes, and a distinctive measure of fiscal capacity or "tax base" is then defined for each type of tax. At the present time, we have 33 tax groupings, or "revenue sources" as we call them, with a distinctive measure of tax base for each such source.

In calculating equalization entitlements for any given fiscal year, we apply the RTS, as defined, to each of the 10 Canadian provinces. This is done by establishing the average provincial tax rate for each revenue source and by applying this standardized rate to a standardized tax base estimated for each province for that source from a common statistical series. The resulting standardized yields of each province for the 33 revenue sources are then summed and compared on a per capita basis with a prescribed per capita standard that is deemed necessary to finance a reasonable level of public services. Where any province's total per capita yield from this system is less than the prescribed per capita standard, it has an equalization entitlement equal to the amount of its per capita shortfall from the standard multiplied by its population.

You will note that the entire calculation is based upon standardized data and, hence, the tax effort of an individual province has virtually no bearing on the amount of its equalization entitlement.

It may be helpful if I were to categorize the 33 revenue sources which make up the present RTS in Canada. These are as follows: 2 income taxes, consisting of personal and corporate income taxes; 10 consumption taxes, including general sales taxes, tobacco taxes, gasoline taxes, taxes on alcoholic beverages and government-run lotteries; 3 taxes on property or assets, including succession duties and property taxes; 12 categories of natural resource revenue for different resources; and 6 other categories including motor vehicle licenses, health insurance premiums and payroll taxes.

The range of taxes is comprehensive, and probably quite comparable with the range of taxes levied by State and local governments in the United States. The only major category of own-source, provincial-local revenue which is missing is revenues from interest and dividends.

A separate measure of fiscal capacity or tax base is defined for each one of the 33 revenue sources. Each measure used for a revenue source should be typical or "representative" of the tax structure actually used by those provinces that levy the tax falling within that source.

I see my time is up. I wonder if I could just deal with the matter of expenditure?

Senator DURENBERGER. Please do, because I was going to ask you a question on that anyway, sir.

Mr. CLARK. I will do that, if I may.

Senator DURENBERGER. Please.

Mr. CLARK. Before concluding, I should return to the matter of interprovincial differences in respect of expenditures, or as we sometimes say, in respect of expenditure need. There is little Canadian experience in the measurement of such differences, and what you in the United States could learn from us in this general area is limited. However, I would like to make three observations on the basic issue of the relevance of interprovincial differences in expenditure need and on how these differences might be measured.

First, unadjusted, raw data suggest that on an overall basis, per capita disparities among Canadian provinces are very much less, and therefore very much less significant, on the expenditures side of government accounts than on the revenue side. This would not be true, of course, for many individual categories of expenditure but is plausible for expenditures as a whole.

Second, the differences which exist among provinces in respect of expenditures have two basic causes. First, there are differences in average per capita needs for public services. Second, there are differences in average unit costs of providing public services. Most economists would agree that there is a valid argument to be made for taking account of differences among provinces in needs for services.

However, some economists contend that the argument for taking account of differences in unit costs is weaker because it would tend to support high cost government operations as against low cost operations and this would not contribute to the overall efficiency of the public sector or of the economy as a whole.

Third, interprovincial disparities in respect to revenues and expenditures are, by and large, independent of each other. It is, therefore, feasible to operate an RTS without taking account of differences among provinces and local governments in respect of expenditures.

However, adoption of the RTS does not negate the possibility of taking interprovincial or interstate differences in expenditures into account. If one wished to take account of interprovincial disparities and expenditures, the most appropriate way of doing this would be by constructing a "representative expenditure system" which could then be superimposed on the representative tax system. The two systems would parallel each other in structure. Whereas the RTS breaks total provincial-local revenues down into revenue sources, the RES would break total provincial-local expenditures into expenditure functions. And whereas the RTS depends upon a measure of fiscal capacity or tax base for each revenue source, the RES would depend upon a measure of expenditure need for each expenditure function.

Senator **Durenberger**. Thank you very much for your testimony.

First, I take it I interpret your testimony correctly when I say that RTS is not a scheme to reward high spending provinces to the disadvantage of low spending provinces; is that correct?

Mr. **Clark**. That is correct.

Senator **Durenberger**. There is another problem we have heard about RTS, and that is that it is so complex and requires so many very politically sensitive decisions in designing it, that it just wouldn't ever be possible to get agreement on some official version. Has that been a problem in Canada?

Mr. **Clark**. No, it hasn't. We have had remarkable harmony in operating the representative tax system in Canada. We began it in 1967. It is part of what we call the "Federal-Provincial Fiscal Arrangements". We review these arrangements every 5 years, and we do this by means of a consultative process with the provinces. We have thoroughly reviewed the representative tax system in 1972, in 1977, and in 1982, and in each case we have looked at the possibility of using a macro measure of fiscal capacity as an alternative, and then we have looked at ways of improving the RTS system.

There has been a strong consensus that we should stay with the RTS and attempt to improve it. We have not had a conflict between the Federal Government on the one hand and provinces on the other or between provinces that get equalization and those that don't, although we now have four provinces that don't receive anything. All provinces participate in the consultative process, and it has really been very harmonious.

Turning to the matter of complexity, the RTS is very complicated. We have often come to a situation where we said, "look, we can do something simply, or we can make it more complicated and try to improve it" and the general reaction we have received from the provinces has been that it is better to try to improve the system even if it becomes more complex. The complexity of the RTS also has the effect of making it very difficult to put it into the public arena of debate because the issues are so complex.

Senator **Durenberger**. What has Canada done about the problem of valuing the property tax base, or is that too technical to try to explain?

Mr. **Clark**. We have what we call capital stock data in Canada. We began publishing data for non-residential capital stock about 6 years ago and for residential stock much earlier. The data for non-residential stock are compiled for each industry on the basis of original cost, which is then adjusted to put it in terms of current value and to allow for depreciation. There are two separate series—one for non-residential capital stock and the other for residential capital stock. We use these series for 70 percent of the tax base. We exclude those categories of property that typically are not taxed, such as church property.

For the land component of the tax base, which constitute 30 percent of the total, we use a macro income measure. We consider that land is a reflection of the total value of goods produced within each province, and we use a measure devised by Statistics Canada which is known as the "provincial gross domestic product." This consists of the value of goods and services produced within the territorial limits of each province. We are now proposing for the coming 5 years to make an adjustment to this concept to take account of, or partial account of, the effects of the Federal-provincial tax-transfer system.

Senator **Durenberger.** What about the matter of user fees? It's possible that the RTS could work againt those entities that put some reliance on financing public services out of user fees.

Have you found a way to reflect that in the system?

Mr. **Clark.** We lump user charges under the head of miscellaneous, and we regard them, in effect, as a substitute for taxes. In the past, we have, again, used our macro economic concept of fiscal capacity to equalize those revenues. We are presently thinking in terms of switching from the macro income measure to what we would call a "composite measure," which would be a weighted average of the fiscal capacity for all of the other nonresource revenues that make up the representative tax system. This, again, would be done on the assumption that user charges are a substitute for taxes.

Senator **Durenberger.** I thank you for your testimony. I'm sure there are others here who would like to ask you questions. The subcommittee is going to have a hearing sometime this summer in Ottawa, and we may use the system that we have employed in other hearings, inviting non-Senators to be Senators, for that experience. Then we will have an opportunity to learn more from you and your colleagues in Canada.

Thank you all very much for your testimony. I appreciate it a great deal.

[The prepared statements of Messrs. Honts, Shannon, and Clark follow:]

PREPARED STATEMENT OF BOB HONTS

STATEMENT ON GENERAL REVENUE SHARING

I. INTRODUCTION

MR. CHAIRMAN, MY NAME IS BOB HONTS. I AM HERE TODAY ON BEHALF OF THE TEXAS ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS WHICH I SERVE AS CHAIRMAN. I AM AN ELECTED COUNTY OFFICIAL IN TRAVIS COUNTY, TEXAS, AND I HAVE BEEN A MEMBER OF THE TEXAS ACIR SINCE 1975. I AM CURRENTLY CHAIRMAN OF THE TAXATION AND FINANCE STEERING COMMITTEE OF THE NATIONAL ASSOCIATION OF COUNTIES (NACO) AND AM A MEMBER OF THE STATE-LOCAL COALITION.

I WILL COMMENT BRIEFLY ON SEVERAL ISSUES CONCERNING THE RENEWAL OF GENERAL REVENUE SHARING--BOTH FROM MY VIEWPOINT AS A MEMBER OF THE TEXAS ACIR AND IN MY POSITION AS A COUNTY OFFICIAL. I WANT TO STRESS THAT MY COMMENTS ARE NOT ON BEHALF OF NACO BUT TEXAS ACIR.

II. TEXAS ACIR

MEMBERS OF THE COMMITTEE MAY NOT BE FAMILIAR WITH THE TEXAS ACIR AND ITS WORK. THE COMMISSION WAS ESTABLISHED BY THE TEXAS LEGISLATURE IN 1971, WITH ITS PURPOSE AND MEMBERSHIP PATTERNED AFTER THE NATIONAL ACIR. THE TEXAS COMMISSION IS COMPOSED OF STATE LEGISLATORS; CITY, COUNTY, SCHOOL, AND SPECIAL DISTRICT REPRESENTATIVES; AS WELL AS PRIVATE CITIZENS. THE LIEUTENANT GOVERNOR AND SPEAKER OF THE HOUSE OF REPRESENTATIVES SERVE AS EX-OFFICIO MEMBERS.

DURING ITS 11-YEAR HISTORY, MUCH OF THE WORK WE HAVE CONDUCTED FALLS INTO TWO AREAS:

- STATE/LOCAL FINANCIAL RELATIONSHIPS; AND
- FEDERAL/STATE/LOCAL GRANT PROGRAMS.

WE HAVE FOLLOWED WITH GREAT INTEREST THE CHANGES IN FEDERAL GRANT PROGRAMS DURING THE LAST TWO OR THREE YEARS, AS WELL AS THE PRESIDENT'S NEW FEDERALISM INITIATIVES. THIS YEAR, OF COURSE, GENERAL REVENUE SHARING IS A MAJOR ITEM ON OUR RESEARCH AGENDA.

III. IMPORTANCE OF GRS TO CITIES AND COUNTIES

I'M SURE YOU HAVE HEARD AMPLE TESTIMONY AS TO THE IMPORTANCE OF GENERAL REVENUE SHARING FOR LOCAL GOVERNMENTS. OF COURSE, REAUTHORIZATION OF GENERAL REVENUE SHARING IS NACO'S TOP LEGISLATIVE PRIORITY IN 1983, AND I TESTIFIED ON THAT ISSUE SEVERAL WEEKS AGO BEFORE THE SENATE FINANCE COMMITTEE.

I WOULD SIMPLY ADD HERE THAT LOCAL GOVERNMENTS IN TEXAS AND AROUND THE COUNTRY BELIEVE THIS IS THE MOST EFFECTIVE GRANT PROGRAM BECAUSE OF ITS FLEXIBILITY AND ITS LOW ADMINISTRATIVE COST. IN THIS PERIOD WHEN CITIES AND COUNTIES ARE ABSORBING BUDGET CUTS IN OTHER PROGRAMS, THE CONTINUATION OF GENERAL REVENUE SHARING IS DOUBLY IMPORTANT.

AREAS OF CONSISTENT CONCERN AMONG COUNTIES AROUND THE COUNTRY ARE: REDUCED EMPLOYMENT, REDUCTIONS IN PROGRAMS FOR THE NEEDY, AND POSTPONEMENT OF STREET, ROAD AND OTHER CAPITAL IMPROVEMENTS. IN SHORT, THE BUCK STOPS AT THE LOCAL GOVERNMENT LEVEL, AND WE HAVE EXTREMELY LIMITED ALTERNATIVES FOR REPLACING LOST FEDERAL DOLLARS. BASICALLY, REPLACEMENT OF FEDERAL REVENUES PROVIDED FROM THE

PROGRESSIVE INCOME TAX WOULD NEED TO BE COVERED BY LOCAL REVENUES FROM THE AD VALOREM PROPERTY TAX. PUBLIC OFFICIALS ARE RELUCTANT TO INCREASE PROPERTY TAXES BECAUSE THAT SOURCE OF REVENUE IS GENERALLY REGARDED AS INEQUITABLE OR REGRESSIVE. ALSO, STATE STATUTORY AND CONSTITUTIONAL LIMITATIONS MAKE IT AN INFLEXIBLE SOURCE IN MANY STATES.

IV. REAUTHORIZATION ISSUES

A. FUNDING BASE

PERHAPS THE MOST IMPORTANT ISSUE CONCERNING REAUTHORIZATION IS THE BASE LEVEL OF FUNDING. OF COURSE, THE ANNUAL ALLOCATION HAS NOT KEPT UP WITH INFLATION AND THUS REPRESENTS SIGNIFICANTLY LESS PURCHASING POWER THAN A FEW YEARS AGO, PERHAPS AS MUCH AS A 40 TO 50 PERCENT REDUCTION.

IT IS APPROPRIATE THAT TWO OF THE BILLS UNDER CONSIDERATION THIS YEAR WOULD PROVIDE FOR ANNUAL INCREASES...AND, I BELIEVE, MAKE UP SOME OF THE LOST SPENDING POWER. ALSO, I WAS INTERESTED TO NOTE THAT THE US ACIR AT ITS MEETING LAST MONTH REAFFIRMED ITS POSITION

THAT REVENUE SHARING SHOULD BE BASED ON A CONSTANT PERCENTAGE OF THE FEDERAL PERSONAL INCOME TAX BASE AND THAT THE PROGRAM BE FUNDED THROUGH A PERMANENT TRUST FUND.

THESE ARE POSITIONS THAT I THINK MOST COUNTY AND CITY OFFICIALS WILL SUPPORT.

B. S 700 FEATURES

THERE ARE SEVERAL IMPORTANT FEATURES OF S 700, SPONSORED BY SENATOR DURENBERGER, THAT I WOULD LIKE TO COMMEND. MOST IMPORTANT, THIS PROPOSAL WOULD REVISE AND EXPAND THE CURRENT PROGRAM. BY TYING THE FUNDING BASE TO THE FEDERAL INCOME TAX, THE PROGRAM WOULD BE MORE FLEXIBLE AND RESPONSIVE TO CHANGING CIRCUMSTANCES. BESIDES PROVIDING MORE FUNDS TO HARD-PRESSED LOCAL GOVERNMENTS, S 700 WOULD ALSO BRING THE STATES BACK INTO THE PROGRAM. THE CURRENT FINANCIAL CONDITION OF MOST OF THE STATE GOVERNMENTS UNDERSCORES THE IMPORTANCE OF CONSIDERING REINSTATEMENT OF THE STATE SHARE OF THE PROGRAM.

I AM CONCERNED SOMEWHAT ABOUT THE POSSIBLE IMPLICATIONS OF ONE FEATURE OF THE BILL. LIMITING THE DEDUCTIBILITY OF STATE AND LOCAL TAX PAYMENTS ON THE FEDERAL INDIVIDUAL INCOME TAX COULD TEND TO RESTRICT STATE AND LOCAL GOVERNMENTS IN ESTABLISHING THEIR OWN TAX BASES. WE WILL WANT TO STUDY THIS PROVISION FURTHER, AS IT COULD HAVE MAJOR IMPLICATIONS.

C. FORMULA

INTERSTATE AND INTRASTATE ALLOCATION ISSUES ARE OBVIOUSLY SENSITIVE, AND EACH ENTITY WILL FARE EITHER BETTER OR WORSE BASED ON DIFFERENT ALLOCATION CRITERIA. IT WAS DIFFICULT FOR CONGRESS TO ESTABLISH THE ALLOCATION PROCEDURES IN 1972, AND FOR THAT REASON I AM APPROACHING THE FORMULA QUESTION WITH CAUTION AND CONCERN. PERHAPS IT IS APPROPRIATE THAT FORMULA ISSUES AT LEAST BE CONSIDERED AFTER 10 YEARS OF OPERATION. WE HAVE, IN MANY CASES, INSUFFICIENT INFORMATION CURRENTLY AVAILABLE ON A BROAD RANGE OF OPTIONS AND THE EFFECTS OF THOSE CHANGES ON THE CURRENT PATTERN OF DISTRIBUTION.

AND SPEAKING NOW AS CHAIRMAN OF TEXAS ACIR, AND AS A TEXAN, I AM CONCERNED ABOUT THE REDISTRIBUTIVE EFFECTS THAT MAY OCCUR WITH CHANGES IN FEDERAL GRANT FORMULAS. YOU ARE AWARE THAT TEXAS AND SOME OF THE OTHER STATES DO NOT RECEIVE AS MUCH BACK UNDER FEDERAL AID PROGRAMS AS THEY PAY IN INCOME TAXES. FOR EXAMPLE, THE TAX FOUNDATION REPORTED THAT IN 1981 TEXAS PAID $1.46 IN TAXES FOR EACH DOLLAR OF FEDERAL AID, WHICH WAS A HIGHER RATIO THAN ANY OTHER STATE. ACTUALLY, 22 STATES PAID IN MORE THAN THEY RECEIVED BACK THAT YEAR.

MY POINT IS THAT THROUGH THE USE OF ''TAX EFFORT'' AND OTHER FACTORS IN GENERAL REVENUE SHARING AND OTHER FEDERAL AID FORMULAS, THE ALLOCATION OF FUNDS AMONG STATES AND LOCALITIES HAS BEEN INFLUENCED DRAMATICALLY. OFFICIALS IN TEXAS AND IN OTHER STATES RECEIVING REDUCED AMOUNTS OF FEDERAL AID WOULD BE ESPECIALLY CONCERNED ABOUT HOW ANY PROPOSED FORMULA CHANGES MIGHT AFFECT THEM, . .AND MORE IMPORTANT, THEIR POPULATIONS FOR WHOM THE GRANTS ARE DESIGNED TO SERVE.

UNDER ANY APPROACH THERE WILL ALWAYS BE WINNERS AND LOSERS, BUT THE MORE FUNDAMENTAL QUESTIONS ARE:

1. WHAT ARE WE REALLY TRYING TO ACCOMPLISH WITH FEDERAL AID FORMULAS?

2. WHO ARE WE TRYING TO AID . . . A STATE, A CITY, A COUNTY, OR A US CITIZEN IN NEED?

3. ARE THE FORMULAS CONSTRUCTED ADEQUATELY TO PERFORM THAT FUNCTION?

D. LET'S ANSWER OUR THREE QUESTIONS AND SEE WHETHER RTS IS THE FORMULA TO ACHIEVE OUR OBJECTIVES.

QUESTION 1: WHAT ARE WE REALLY TRYING TO ACCOMPLISH WITH FEDERAL AID FORMULAS?

REGIONALISM ASIDE, I HOPE THE ANSWER IS THAT THE REAL PURPOSE OF FEDERAL ASSISTANCE IS TO ASSIST PERSONS IN NEED . . .WHO, FOR VARIOUS REASONS, PRIVATE OR PUBLIC, NEED SUCH ASSISTANCE.

SENATOR HUBERT HUMPHREY ONCE SAID:

'' THE REAL MORAL TEST OF GOVERNMENT IS HOW IT TREATS THOSE WHO ARE IN THE DAWN OF LIFE, THE CHILDREN; THOSE WHO ARE IN THE TWILIGHT OF LIFE, THE AGED; AND THOSE WHO ARE IN THE SHADOWS OF LIFE, THE SICK AND NEEDY, AND THE HANDICAPPED.''

NOWHERE IN THIS FAMOUS QUOTE FROM THIS WORTHY AMERICAN DO I READ OR HEAR THAT WE ARE ATTEMPTING TO REDISTRIBUTE WEALTH, EXCEPT TO MEET THE NEEDS OF PEOPLE, WHO IN TURN NEED THE HELP.

QUESTION 2: WHO ARE WE TRYING TO AID . . . A STATE, A CITY, A COUNTY, OR A US CITIZEN SERVED BY THE SAME?

THE ANSWER IS OBVIOUS. WE ARE TRYING TO AID CITIZENS WHO NEED HELP, NOT BASED ON WHERE THEY LIVE, BUT BASED ON THEIR NEED.

- THE ELDERLY
- THE UNEMPLOYED AND THE HOMELESS
- THE HANDICAPPED AND THE SICK
- THE YOUNG WHO NEED HELP
- THE POOR AND UNSKILLED

I SUBMIT TO YOU THAT ALL AND ANY OF THESE IN ALL 50 STATES SHOULD RECEIVE ASSISTANCE BASED ON THEIR NEED TO RECEIVE IT AND THEIR OWN PROVEN AND DEMONSTRATED INABILITY TO PROVIDE IT FOR THEMSELVES. I SUBMIT THAT AN ELDERLY PERSON OR HOMELESS PERSON IN TEXAS OR IN CONNECTICUT HAS JUST AS MUCH RIGHT TO US AID AS A SIMILAR PERSON IN OHIO OR PENNSYLVANIA.

BUT THEY HAVEN'T BEEN GETTING IT, AND WORSE, UNDER THE RTS SYSTEM, THEY WON'T GET EVEN AS MUCH AS BEFORE--NOT BECAUSE THEIR NEED IS LESS OR THEIR INCOME OR RESOURCES ARE GREATER, BUT BECAUSE THEIR STATE, UNDER AN ARBITRARY FORMULA, CAN POTENTIALLY TAX MORE THAN ANOTHER STATE.

THE FACT THAT THE TEXAS POOR PERSON IS POORER DOESN'T COUNT, AND RTS DOES NOT MEASURE NEED. NOR DOES IT MEASURE THE PHILOSOPHY OR OTHER CONSTRAINTS THAT MAY CAUSE STATE LEADERS NOT TO BE WILLING OR ABLE TO MEET THAT PERSON'S NEED.

I SUBMIT THAT YOU AS SENATORS SHOULD ADDRESS NEEDS OF US CITIZENS WHO NEED YOUR HELP--SHOULD SEND WHATEVER AID YOU CAN SPARE ON THAT BASIS, ON A REASONABLY SIMPLE FORMULA.

LET ME GIVE YOU AN EXAMPLE OF HOW PAST FORMULAS HAVE, BY INTENTION OR BY ACCIDENT, ''SKEWED'' THE RESULT.

- AGE OF HOUSING, ADDED TO COMMUNITY DEVELOPMENT BLOCK GRANT FORMULA (NUMBER OF UNITS BUILT PRIOR TO 1940). NOT SUBSTANDARD, INADEQUATE OR UNSAFE AND UNSANITARY HOUSING, BUT OLD HOUSING (BUILT PRIOR TO 1940).

NOW I ASK, WHAT STATES OR INDIVIDUALS WIN OR LOSE WITH THAT ELEMENT?

I SUBMIT THAT SOME OF THE NATIONS OLDEST HOMES ARE THEIR BEST. . .THEIR BIGGEST. . . AND LEAST SUBSTANDARD. (I SUPPOSE THE WHITE HOUSE WOULD QUALIFY WITH THIS ELEMENT . . .) AND I CAN SHOW YOU SLUMS IN THE RIO GRANDE VALLEY OR IN HOUSTON WHERE SOME OF THE NEWEST ARE THE MOST UNSAFE, UNSOUND, UNSANITARY, AND INADEQUATE. THIS IS AN EXCELLENT EXAMPLE OF A NOBLE FORMULA THAT DOES NOT MEASURE NEED AND THAT TENDS TO SEND HOUSING AID TO THE WRONG PLACES AND FOR THE WRONG PERSONS.

NOT ONLY THAT, BUT THE PRE-1940 ASPECT OF THE FORMULA IGNORES THE IMPACT OF POPULATION SHIFT SINCE 1940, AND IN MY STATE, 7,813,559 MORE PEOPLE, A 122 PERCENT GROWTH, ARE IGNORED IN THAT PART OF THE FORMULA. IN FACT, THE FORMULA MOVES MONEY AWAY FROM THE SOUTH AND WEST, WHICH IN MANY WAYS, COMPARE WITH THE WORST OF THE STATES IN SUBSTANDARD HOUSING.

ANOTHER EXAMPLE IS THE LARGE TRUST FUND CREATED BY PRESIDENT REAGAN'S ''NEW FEDERALISM PLAN,'' WHICH DISTRIBUTES FUNDS ON THE BASIS OF SO-CALLED ''HISTORIC SHARES.'' THESE SHARES ARE BASED ON THE 1970 CENSUS OR SURVEYS TAKEN IN THE 1970S. IS THAT FAIR TO A STATE, LIKE TEXAS, THAT GREW 26.4 PERCENT IN THE 70'S AND WILL LIKELY DO IT AGAIN IN THE 80'S (DURING THE GRANT PERIODS)?

QUESTION 3: ARE THE FORMULAS CONSTRUCTED ADEQUATELY TO PERFORM THE INTENDED FUNCTION?

ON THE ISSUE OF FORMULA CONSTRUCTION, I COMMEND THE US ACIR AND THE AUTHOR OF S 700 FOR THE MOTIVE OF LOOKING FOR A BETTER WAY TO ALLOCATE FEDERAL GRANT DOLLARS. BY ELIMINATING

THE TAX EFFORT FACTOR, S 700 IS CERTAINLY A STEP IN THE RIGHT DIRECTION. TAX EFFORT HAS BEEN A MAJOR FACTOR IN THE CURRENT FORMULA, AND IT CLEARLY SHIFTS FUNDS AWAY FROM FISCALLY CONSERVATIVE JURISDICTIONS AND REWARDS STATES AND LOCALITIES THAT HAVE HIGH TAXES REGARDLESS OF THEIR ACTUAL EXPENDITURE NEEDS. THIS MAY OR MAY NOT BE THE RESULT THAT WAS INTENDED ORIGINALLY, BUT IT IS CERTAINLY AN IMPORTANT ISSUE.

ALSO, TAX EFFORT IN THE CURRENT FORMULA OVERLOOKS THE IMPORTANCE OF USER CHARGES AS A MEANS OF FINANCING GOVERNMENT SERVICES IN MANY STATES. I AM SURE YOU ARE AWARE THAT THE US GENERAL ACCOUNTING OFFICE HAS STUDIED THE CURRENT GENERAL REVENUE SHARING FORMULAS AND CONCLUDED THAT USER CHARGES SHOULD BE INCLUDED WITHIN THE TAX EFFORT MEASURE. IN ESSENCE, THE GAO FOUND THAT USER CHARGE FINANCING IS GROWING RELATIVE TO TAX FINANCING AMONG LOCAL GOVERNMENTS NATIONALLY, AND THEREFORE, THE MEASUREMENT OF TAX EFFORT SHOULD BE BROADENED TO INCLUDE THAT SOURCE. THIS UNDERSCORES THE PROBLEMS WITH THE TAX EFFORT FACTOR, AND SUGGESTS THE NEED FOR

AN IMPROVED BASIS FOR ALLOCATING FUNDS.

PER CAPITA INCOME WOULD ALSO BE ELIMINATED FROM THE ALLOCATION FORMULA UNDER S 700. ALTHOUGH IT IS A BROAD MEASURE, I AM NOT CONVINCED IT SHOULD BE TOTALLY EXCLUDED. PER CAPITA INCOME IS A REFLECTION OF THE COMPARATIVE WELL BEING OF INDIVIDUALS, AND I THINK, THEREFORE, A LEGITIMATE INDICATOR OF NEED. SOME MEASURE OF INDIVIDUAL INCOME IS CURRENTLY USED AS A FACTOR IN THE DISTRIBUTION FORMULAS OF ABOUT 29 FEDERAL AID PROGRAMS, AND I THINK THIS REFLECTS A GENERAL ACCEPTANCE OF PER CAPITA INCOME BOTH AS A MEASURE OF ABILITY TO PAY AS WELL AS RELATIVE NEED. I WOULD URGE YOU TO CONSIDER CAREFULLY THE ADVANTAGES, AS WELL AS ANY PERCEIVED DISADVANTAGES, OF RETAINING PER CAPITA INCOME AS A FACTOR IN SOME WAY.

IN TERMS OF THE RTS, TAX CAPACITY IS THE MAJOR FACTOR THAT WE ARE CONCERNED WITH. IT IS A MEASURE OF THE ABILITY OF GOVERNMENTS TO RAISE MONEY. AS I POINTED OUT EARLIER, THE

NEEDS OF PEOPLE ARE THE FOREMOST CONSIDERATION AND SHOULDN'T BE SLIGHTED THROUGH ALLOCATION FORMULAS.

ANOTHER ISSUE IS THAT RTS MEASURES STATE AND LOCAL FISCAL CAPACITY AS A UNITARY CONCEPT. OF COURSE, LOCAL GOVERNMENTS' ABILITIES TO RAISE FUNDS ARE LIMITED BY STATE CONSTITUTIONS AND LAWS AS WELL AS BY THE SIZE OF THE TAX BASE. THEREFORE, ALTHOUGH A STATE HAS SIGNIFICANT FISCAL CAPACITY, LOCAL GOVERNMENTS IN THAT STATE MAY NOT HAVE ACCESS TO THE POTENTIAL REVENUE SOURCES BECAUSE OF STRICT CONSTITUTIONAL AND STATUTORY TAX RATES AND LIMITED REVENUE SOURCES. THEREFORE, THESE CITIES AND COUNTIES WOULD BE DOUBLY PUNISHED UNDER THE RTS APPROACH.

OF COURSE, YOU ARE AWARE OF THE TECHNICAL CONSIDERATIONS CONCERNING THE RTS. THE US ACIR IN ITS OWN REPORT POINTED OUT SEVERAL AREAS OF CONCERN, SUCH AS MEASUREMENT PROBLEMS AND THE USE OF ESTIMATES TO DEVELOP THE STATE SHARES. THE GENERAL ACCEPTABILITY OF THESE ESTIMATING TECHNIQUES AMONG THE STATES WOULD BE AN IMPORTANT ISSUE TO CONSIDER.

V. CONCLUSION

MR. CHAIRMAN, IN CLOSING I WOULD LIKE TO EMPHASIZE THE IMPORTANCE OF THE REAUTHORIZATION PROCESS. GENERAL REVENUE SHARING IS A CRITICAL ISSUE FOR COUNTIES AND OTHER LOCAL GOVERNMENTS, AND RENEWAL THIS YEAR IS ESSENTIAL. THE CONSIDERATION OF POTENTIAL CHANGES IN THE FORMULA IS APPROPRIATE, BUT I AM CONCERNED ABOUT THE POSSIBLE EFFECTS THAT MAJOR FORMULA CHANGES MAY HAVE ON THE STATES AND LOCALITIES. WE WOULD, OF COURSE, WELCOME THE OPPORTUNITY TO WORK WITH YOUR STAFF AND THE US ACIR IN COMPARING ANALYSES OF FORMULA CHANGES AND IN REVIEWING THEM AS POSSIBLE ALTERNATIVES TO THE CURRENT SYSTEM.

THANK YOU FOR THE OPPORTUNITY TO TESTIFY. I COMMEND YOUR EFFORTS IN REVIEWING THE PROGRAM AND LOOKING FOR WAYS TO IMPROVE IT. I HOPE THAT WE MAY WORK TOGETHER IN THE FUTURE TOWARD THAT END.

PREPARED STATEMENT OF DR. JOHN SHANNON

Mr. Chairman, I appreciate this opportunity both to present the Commission's position on Revenue Sharing and to respond to your request for a description of the Representative Tax System as a means of measuring the tax capacity of states.

GENERAL REVENUE SHARING RENEWAL

On the issue of General Revenue Sharing (GRS), the Advisory Commission on Intergovernmental Relations has had a long and firm record of support. At its recent meeting in Charleston, South Carolina, the Commission reaffirmed that support with an endorsement that reads as follows:

> Over the last two decades, the Advisory Commission on Intergovernmental Relations has consistently supported the general revenue sharing concept and has endorsed three principles to govern this program.
>
> To ensure adequate coverage, the Commission has recommended that states and local governments be made direct program beneficiaries.
>
> To ensure program certainty, the Commission has urged the use of a permanent trust as the funding mechanism.
>
> To ensure funding adequacy and growth, the Commission has called for sharing of a constant percentage of the federal personal income tax base.

The point must be emphasized that the Commission did not recommend any basic changes in the formula for distributing GRS funds. However, many persons interested in formula changes have suggested, among other things, a switch from the current per capita income measure to the Representative Tax System approach for estimating the tax capacity of the states.

THE REPRESENTATIVE TAX SYSTEM FOR MEASURING STATE TAX CAPACITY

Over the last 20 years, a series of ACIR information reports have emphasized both the inadequacies of the per capita income approach and the need for building a better yardstick. In fact, our earliest report on this subject dates back to 1962; it first presented an alternative yardstick--the Representative Tax System--for measuring state tax capacity.1/

That pioneering staff effort made a stronge impression in Canada. As the Canadian representative, Mr. Clark, will probably point out in his testimony, the 1962 report played a part in the Canadian Parliament's decision to begin distributing federal equalization aid to the provinces using the Representative Tax System method for estimating provincial tax wealth.

1/ ACIR, Measures of State and Local Fiscal Capacity and Tax Effort, M-16, Washington, D.C., 1962. See also ACIR, Measuring the Fiscal Capacity and Effort of State and Local Areas, M-58, 1971; ACIR, Tax Capacity of the Fifty States: Methodology and Estimates, M-134, March 1982; and ACIR, Tax Capacity of the Fifty States, Supplement: 1980 Estimates, June 1982.

In March of 1982, the Commission found that the use of a single yardstick, resident per capita income, to measure fiscal capacity seriously misrepresents the actual ability of many governments to raise revenue. In short, this misrepresentation results in a systematic overstatement or understatement of the ability of many states to raise revenue.

Mr. Chairman, I would like to make several observations that are intended both to explain the Representative Tax System (RTS) concept and to respond to certain charges leveled against it by its critics.

First, the Representative Tax System is a sophisticated yardstick for measuring the relative tax capacity of each of the 50 state-local systems. It answers this question: How would each of the 50 states rank on a tax productivity scale if every state applied identical tax rates (national averages) to each of the 26 commonly used tax bases.1/

Second, this Representative Tax System yardstick was created because the present measure used by the Congress--state per capita income--has three serious deficiencies.

1/ Appendix A provides a step-by-step description of the technique used by ACIR in constructing its Representative Tax System and Appendix B sets forth the representative tax bases (or proxies) and the representative tax rates (national averages).

These shortcomings can be summarized as follows: the per capita income measure significantly understates the tax wealth of energy rich as well as tourist rich states and overstates the tax wealth of several frostbelt states confronted with declining economic bases. (Table 1)

Table 1
EXTREMES OF OVER- AND UNDER-ESTIMATION OF STATE-LOCAL TAX CAPACITY BY THE CONVENTIONAL PER CAPITA INCOME MEASURE (1981)1/

State	RTS Tax Capacity Index 2/	Per Capita Income Index 3/	Using Per Capita Income, Tax Capacity is: Under-estimated	Using Per Capita Income, Tax Capacity is: Over-estimated
Alaska	324	131	-193	
Wyoming	216	111	-105	
Nevada	148	110	-38	
New Mexico	114	81	-33	
Texas	132	102	-30	
Oklahoma	127	98	-29	
North Dakota	124	97	-27	
Louisiana	117	91	-26	
Montana	114	90	-24	
West Virginia	90	80	-10	
New York	89	109		+20
Dist. of Col.	111	129		+18
Rhode Island	80	97		+17
Connecticut	110	122		+12
Maryland	98	109		+11
New Jersey	105	115		+10
Massachusetts	96	106		+10

(U.S. Average = 100)
1/ States with deviation of 10 or more percentage points.
2/ Based on the ACIR-NIE representative tax system approach.
3/ The per capita measure of personal income currently used in federal formulas.
Source: ACIR staff estimates.

Third, the Representative Tax System has been unjustly criticized as being biased in favor of big spending states. Notwithstanding these dogged assertions, the Representative Tax System approach does not discriminate in favor of the heavy taxing states and against light taxing states. The relative capacity rating for each state does not depend on its taste for public goods and services. Moreover, the tax capacity index for each state would be the same whether all the representative tax rates (national averages) used in the calculation were cut in half or doubled.

It is the tax effort factor in the General Revenue Sharing formula--not the tax capacity measure--that works in favor of a heavy spending state such as New York. For example, if the tax effort factors were stripped out of the GRS formula and the Representative Tax System measure were substituted for the per capita income yardstick, the relatively light spending state of Texas would receive an additional $10 million in GRS funds while the heavy spending state of New York would have its 1983 General Revenue Sharing allotment cut by approximately $90 million.

Fourth, some who oppose introduction of the Representative Tax System claim that its utilization should wait until there is a comparable breakthrough on the expenditure side to ensure that both revenue capacity and expenditure needs are adequately weighed. Unfortunately, this counsel of perfection is the counsel of interminable delay. It is difficult enough to measure state revenue capacity; it is virtually impossible to get agreement on what constitutes legitimate expenditure needs.

Fifth, the Representative Tax System approach has been criticized as being too complex. There is no question but that the Representative Tax System yardstick is far more complicated than is the per capita income measure. There is, however, the obvious rejoinder--for every complex problem there is an answer that is neat, simple, and wrong. The very neat and simple per capita income measure produces the wrong answers for many of the energy rich states, for some of the tourist states, and for several Frostbelt states.

Sixth, although the RTS has some data imperfections, it still stands out as a far more accurate yardstick of state tax capacity than does the per capita income measure. There is no question that the RTS has certain data problems--the most important being the lack of annual property tax valuations. Nevertheless, on a scale of 1 to 100, I would score the accuracy of the RTS measurement at least 90 and the per capita income measure no more than a 70. In my judgment, a B+ performance should be favored over the D- performance every day of the week.

Mr. Chairman, this concludes my remarks.

APPENDIX A

RTS METHODOLOGY

For each of the 26 tax bases included, a representative ("average") tax rate is calculated. That rate is then applied to the tax base available for such taxation in each state. This multiplication shows the amount each state would collect if it levied that tax at the "average" national rate. The 26 separate tax collection calculations for each state can then be added to get the total tax capacity of each state and the states can be compared on a per capita basis. Each of these steps in the measurement process is described and illustrated below.

Step 1 --
Compute 26 representative tax rates according to the nationwide tax collections of all states and localities and the nationwide tax base amounts.

For example, the representative general sales and gross receipts tax rate of 6.5% (1980) was obtained by dividing the $51,175,484,000 state and local general sales and gross receipts tax collections by national retail sales of $791,261,640,000 (excluding food or drugs). The representative rates for each of the 26 tax bases are shown on Attachment B.

Step 2--
Determine the hypothetical per capita yield for each tax in each state by applying the representative (average) tax rate to that state's actual tax base.

For example, when applied to the Mississippi sales and gross receipts tax base of $5,935,123,000, the 6.5% representative sales and gross receipts tax rate produced $152 per capita. However, in a tourism rich state like Nevada with a tax base of $7,347,051,000, the 6.5% rate produced $593 per resident. More spectacularly, although the representative rate of 4.98% on the value of oil and gas production produced an average of $19 per U.S. resident, in Alaska it produced $1,167 per resident.

Step 3 --
Determine the hypothetical tax wealth or capacity for each state by adding together the per capita yields for each of the 26 taxes.

APPENDIX A (Continued)

> The 26 representative base times rate calculations together produced an average of $949 per U.S. resident (1980), whereas for Mississippi, the poorest state, the yield was $658 per resident, and for Alaska, the richest, the yield was $2,463 per resident.

Step 4 —
Index the results for each state to the U.S. average, $949; an index of 100 corresponds to the U.S. average per capita tax yield.

> For example, Mississippi, with a per capita yield of $658, has an index of 69.3, meaning that Mississippi has only 69.3% of the average tax capacity. For Alaska, the index is 259.7, denoting capacity 259.7% of the U.S. average in 1980.

APPENDIX B

INFORMATION UNDERLYING THE REPRESENTATIVE TAX SYSTEM FOR STATE AND LOCAL GOVERNMENTS FOR 1980

TAX	State-Local Tax Collections		Tax Base		Representative Tax Rate
	(Billions of Dollars)	% of Total	Amounts in Millions	Description	
1. General Sales or Gross Receipts	$51.2	23.7%	$791,261.6	Retail sales & receipts of selected service industries	6.5%
2. Selected Sales	26.5	12.3	—	—	—
a. Motor Fuel	9.8	4.6	115,968.0	Fuel consumption in gallons	$.08/gallon
b. Distilled Spirits	1.6	0.8	449.9	Consumption of distilled spirits in gallons	$3.63/gallon
c. Beer	.8	0.4	117.8	Consumption of beer in barrels	$4.65/barrel
d. Wine	.2	0.1	471.8	Consumption of wine in gallons	$.39/gallon
e. Tobacco	3.9	1.8	29,184.5	Cigarette consumption in packages	$.13/package
f. Insurance	3.1	1.5	$199,138.0	Insurance premiums for life, health, property & liability insurance	1.57%
g. Public Utilities	6.0	2.8	$200,862.0	Revenues from electric, gas, and telephone companies	3.00%
h. Parimutuels	.7	0.3	$13,802.1	Parimutuel turnover from horse and dog racing	5.23%
i. Amusements	.3	0.1	$28,279.0	Receipts of amusement and entertainment business	1.07%
3. License Taxes	7.7	3.3	—	—	—
a. Automobiles	3.2	1.5	120.9	Private automobile registrations	$26.42/registration
b. Trucks	2.1	1.0	32.2	Private truck registrations	$66.14/registration
c. Motor Vehicle Operators	.4	0.2	145.3	Motor vehicle operators' licenses	$2.69/license
d. Corporations	1.4	0.6	2.71	Number of corporations	$512.58/corporation
e. Alcoholic Beverage	.2	0.1	0.271	Licenses for the sale of distilled spirits	$666.79/license
f. Hunting & Fishing	.4	0.2	62.2	Number of hunting & fish. licenses	$6.71/license
4. Individual Income	41.4	19.2	$247,386.3	Federal income tax liability	16.72%
5. Corporate Income	13.5	6.3	$214,634.0	Corporate income	6.29%
6. Property	68.3	31.7	—	—	—
a. Residential	37.4	17.3	$2,955,168.0	Market value of residential property	1.27%
b. Commercial-Industrial	22.0	10.2	$1,561,570.0	Net book value of inventories, property, plant & equipment of corporations	1.41%
c. Farm	4.1	1.9	$670,075.0	Market value of farm real estate	0.61%
d. Public Utilities	4.9	2.3	$398,744.3	Net book value of fixed assets for electric, gas, & telephone companies	1.22%
7. Estate & Gift	2.0	0.9	$6,484.5	Federal estate & gift tax receipts	31.54%
8. Severance	4.9	2.3	—	—	—
a. Oil & Gas	4.2	2.0	$84,981.8	Value of oil & gas production	4.98%
b. Coal	.4	0.2	$21,650.3	Value of coal production	2.14%
c. Non-fuel Minerals	.2	0.1	$26,098.0	Value of non-fuel mineral production	0.78%
U.S. TOTAL	$215.5	100.0			

Note: Detail may not add to totals due to rounding.

Source: ACIR

APPENDIX C

1981 REPRESENTATIVE TAX SYSTEM ESTIMATES (Preliminary) COMPARED TO PERSONAL INCOME

Region State	Per Capita Tax Capacity	Index: Tax Capacity	1981 Personal Income Per Capita	Income Index
New England				
Connecticut	$1,131	109.9	$12,816	122.2
Maine	$815	79.2	$8,535	81.4
Massachusetts	$988	96.0	$11,128	106.1
New Hampshire	$982	95.5	$9,994	95.3
Rhode Island	$827	80.4	$10,153	96.8
Vermont	$864	84.0	$8,723	83.1
Mideast				
Delaware	$1,143	111.1	$11,095	105.8
Washington D.C.	$1,142	111.0	$13,539	129.1
Maryland	$1,009	98.0	$11,477	109.4
New Jersey	$1,077	104.7	$12,127	115.6
New York	$916	89.0	$11,466	109.3
Pennsylvania	$931	90.4	$10,370	98.8
Great Lakes				
Illinois	$1,070	103.9	$11,576	110.3
Indiana	$932	90.6	$9,720	92.7
Michigan	$990	96.2	$10,790	102.9
Ohio	$971	94.4	$10,313	98.3
Wisconsin	$935	90.9	$10,035	95.7
Plains				
Iowa	$1,053	102.3	$10,474	99.8
Kansas	$1,125	109.3	$10,813	103.1
Minnesota	$1,030	100.1	$10,768	102.6
Missouri	$947	92.1	$9,651	92.0
Nebraska	$996	96.8	$10,366	98.8
North Dakota	$1,271	123.5	$10,213	97.4
South Dakota	$888	86.3	$8,833	84.2
Southeast				
Alabama	$766	74.5	$8,219	78.3
Arkansas	$839	81.6	$8,044	76.7
Florida	$1,040	101.1	$10,165	96.9
Georgia	$838	81.4	$8,934	85.2
Kentucky	$843	82.0	$8,420	80.3
Louisiana	$1,200	116.6	$9,518	90.7
Mississippi	$737	71.6	$7,408	70.6
North Carolina	$818	79.5	$8,649	82.4
South Carolina	$774	75.2	$8,039	76.6
Tennessee	$812	79.0	$8,447	80.5
Virginia	$969	94.1	$10,349	98.6
West Virginia	$926	90.0	$8,377	79.8
Southwest				
Arizona	$913	88.7	$9,754	93.0
New Mexico	$1,170	113.6	$8,529	81.3
Oklahoma	$1,310	127.3	$10,247	97.7
Texas	$1,359	132.1	$10,729	102.3
Rocky Mountain				
Colorado	$1,160	112.8	$11,215	106.9
Idaho	$891	86.6	$8,937	85.2
Montana	$1,168	113.5	$9,410	89.7
Utah	$890	86.5	$8,313	79.2
Wyoming	$2,227	216.4	$11,665	111.2
Far West				
California	$1,186	115.2	$11,923	113.6
Nevada	$1,523	148.0	$11,576	110.3
Oregon	$1,019	99.0	$10,008	95.4
Washington	$1,020	99.1	$11,277	107.5
Alaska	$3,333	323.8	$13,763	131.2
Hawaii	$1,076	104.6	$11,036	105.2
US Average	$1,029	100.0	$10,491	100.0

Source: ACIR staff.

APPENDIX D

TRENDS IN STATE TAX CAPACITY, SELECTED YEARS 1967-1981

State	Tax Capacity Index				
	1967	1975	1979	1980	1981P
New England					
Connecticut	117	110	108	112	110
Maine	81	84	80	80	79
Massachusetts	98	98	93	96	96
New Hampshire	110	102	96	97	96
Rhode Island	91	88	84	84	80
Vermont	88	94	85	84	84
Mideast					
Delaware	123	124	109	111	111
Washington, D.C.	121	117	110	111	111
Maryland	101	101	99	99	98
New Jersey	107	109	102	105	105
New York	108	98	89	90	89
Pennsylvania	91	98	93	93	90
Great Lakes					
Illinois	114	112	112	108	104
Indiana	99	98	98	92	91
Michigan	104	100	104	97	96
Ohio	100	103	101	97	94
Wisconsin	94	98	99	95	91
Plains					
Iowa	104	106	108	105	102
Kansas	105	109	109	109	109
Minnesota	95	97	105	102	100
Missouri	97	96	97	94	92
Nebraska	110	106	100	97	97
North Dakota	92	101	109	108	124
South Dakota	91	94	95	90	86
Southeast					
Alabama	70	77	76	76	75
Arkansas	77	78	77	79	82
Florida	104	102	100	100	101
Georgia	80	86	81	82	81
Kentucky	80	85	85	83	82
Louisiana	94	97	103	109	117
Mississippi	64	70	70	69	72
North Carolina	78	84	82	80	80
South Carolina	64	77	76	75	75
Tennessee	78	84	81	79	79
Virginia	86	93	93	95	94
West Virginia	75	89	92	94	90
Southwest					
Arizona	95	92	91	89	89
New Mexico	94	92	103	107	114
Oklahoma	102	98	108	117	127
Texas	98	110	117	124	132
Rocky Mountain					
Colorado	104	106	110	113	113
Idaho	91	89	91	87	87
Montana	105	103	113	112	114
Utah	87	86	87	86	87
Wyoming	141	153	173	196	216
Far West					
California	124	110	116	117	115
Nevada	171	145	154	154	148
Oregon	106	100	106	103	99
Washington	112	98	103	103	99
Alaska	99	154	217	260	324
Hawaii	99	110	103	107	105
U.S. AVERAGE	100	100	100	100	100

P = preliminary.

Source: ACIR staff.

PREPARED STATEMENT OF DOUGLAS CLARK

CANADIAN EXPERIENCE WITH THE REPRESENTATIVE TAX SYSTEM AS A MEANS OF MEASURING THE RELATIVE FISCAL CAPACITIES OF PROVINCIAL AND LOCAL GOVERNMENTS

(Testimony before the United States Senate Committee on Governmental Affairs Subcommittee on Intergovernmental Relations, April 6, 1983)

Members of the Senate Subcommittee on Intergovernmental Relations: I have been invited by your Chairman to provide you with information concerning the use and operation of the Representative Tax System (RTS) in Canada. It is an honour and privilege to comply with this request and I hope that the information I am able to provide will be helpful to you. The remarks which I make are personal and should not be attributed to the Government of Canada.

Any reference before an American audience to the use of the RTS in Canada should begin by acknowledging our debt to the Advisory Commission on Intergovernmental Relations. Indeed the ACIR may be said to have "invented" this system back in 1962 with the publication of its landmark document entitled "Measures of State and Local Fiscal Capacity and Tax Effort", following work by a group of well-known American economists which included Ecker-Racz, Mushkin, Manvel, Peckman and Shoup. We in Canada moved, rather quickly, to import this product of Yankee ingenuity - taking full advantage of the absence of any patent royalties, copyright royalties, trademark fees, export charges, import tariffs or other barriers to trade. This was done back in 1967, when the RTS was introduced into an existing Fiscal Equalization Program which had been in place since 1957. While that existing system was based upon the methodology used in an RTS, it took account of only 3 categories of revenue and the origin of the RTS in Canada can properly be dated from 1967. By 1986, when present legislation governing equalization expires, the RTS will have been in operation for 20 years.

USES OF THE RTS

The principal portion of what I have to say concerns the use of the RTS in the Fiscal Equalization Program. However, I should note that we use it for other purposes as well. First, we use it to construct indices of fiscal capacity and tax effort which are important analytical tools in any fiscal comparison of provinces. Second, last year we built the RTS into a long-term revenue-sharing agreement between Canada and Nova Scotia, pursuant to which Canada will share specified revenues from offshore resources situated in a zone adjacent to Nova Scotia, with the extent of such sharing depending upon that Province's level of fiscal capacity. Other uses for the RTS are likely to be found in the future.

Let me now turn to the Fiscal Equalization Program. This is a major federal program that involves annual, unconditional payments to provinces. These payments are presently running at a level of $5 billion and constitute almost 6 per cent of total federal expenditures. The purpose of equalization, as set out in the Constitution of Canada, is "to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation". Accordingly, payments are made to those provinces that are unable, from their own resources, to finance some reasonable level of public services. While the term "reasonable level of public services" is not defined in the Constitution, it is clearly a relative term requiring that consideration be given to service levels in provinces as a whole. Although equalization payments are made to provincial governments they take account of the collective capacities and needs of local governments in each province as well, it being assumed that payments to a province will inevitably benefit its local governments and that a province together with its local governments constitute a single fisc.

In determining provincial entitlements to equalization we have always made the implicit assumption that each Canadian province can provide the overall level of public services with which equalization is concerned at the same per capita cost. This undoubtedly is an oversimplification and is a matter to which I will refer later. There is, however, general agreement in Canada that interprovincial disparities in provincial public finance arise mainly on the revenue side of the ledger and, accordingly, that the key issue to be addressed is how to compare provinces in their relative capacities to derive revenues from taxation and other sources under their control.

ALTERNATIVES TO THE RTS

While the RTS has been chosen as the means by which provinces are compared in respect of fiscal capacity, this approach was not chosen because it was the only one available. When the federal government first considered the RTS approach in the mid-1960's, and indeed ever since that time, it has realized that there are two basic ways in which the revenue-raising capacities of provinces can be compared. These are by means of a "macro" approach and a "micro" approach. The micro approach, of course, is the RTS.

Where a macro approach is used, one would search for some broad single measure, or perhaps two measures, of income or of value of production out of which all taxes may be said to be paid. Such an approach would have some advantages over an RTS and I might refer to two of these. First, a macro approach would avoid a potential problem because an RTS may induce provincial or state governments to take certain actions to influence the size of their tax bases, as measured in the RTS, with a view to increasing the amount of any RTS-based transfer payments from the national government. We are aware of this potential problem in Canada, but have found very little evidence that provinces have ever taken actions of this kind. Second, a macro approach would avoid problems which may arise because of the interaction between tax rates and tax bases. To cite an example, if Province A has a higher gasoline tax than Province B, the resulting price differential will reduce consumption of gasoline in Province A vis-a-vis that of Province B. Assuming that gasoline consumption data are used as the measure of fiscal capacity for gasoline tax revenues, there will be a distortion of the potential tax base, with that of Province A being understated and that of Province B overstated. This again does not appear to be a major problem in the context of comparing the overall fiscal capacities of provinces or states.

Although the advantages of a macro measure of fiscal capacity do not appear to be important, we have examined this approach seriously in Canada. In so doing, we have concluded that it could best be implemented by using two macro measures of fiscal capacity in tandem. These would consist, first, of provincial gross domestic product at market prices, and second, of provincial gross national product. The gross domestic product of a province would consist of the total value, at market prices, of goods and services produced within its geographic boundaries. The gross national product of a province would consist of the total value, at market prices, of goods and services attributable to its residents, irrespective of the geographic location of production. In our view gross domestic product would be a feasible measure of fiscal capacity for those revenues that are "source-based", such as natural resource levies, property taxes and probably corporation income taxes, where a province's capacity to tax is related to the geographic location of assets or productive facilities. On the other hand, gross national product would be a feasible measure of fiscal capacity for those revenues that are "residence-based", such as personal income and consumption taxes, where a province's capacity to tax is related to the incomes of its residents irrespective of the geographic origin of that income.

In Canada we do not, as yet, have statistical data on the gross national product of provinces. We have had data available on gross domestic product for several years and have, in fact, made use of it in the RTS as a measure of fiscal capacity for miscellaneous taxes and revenues and as a proxy for the land component of the property tax base.

We have also examined the national economic accounts concept of personal income as a possible measure of fiscal capacity.

We have concluded that it is not a satisfactory measure of overall fiscal capacity because it does not provide adequate representation for the income of business. Not only do provinces and local governments derive a substantial portion of their revenues from business, but also this income is relatively uneven in its distribution and its accessibility to provinces. In addition, personal income does not take account of the uneven ability of provinces to export their taxes to other jurisdictions, in large part because of its under-representation of the business sector through which most tax exportation is channelled.

Although macro measures of fiscal capacity are available and do have certain advantages, there is a strong consensus among Canadian governments that these advantages are considerably outweighed by the disadvantages. The most fundamental disadvantage of a macro measure of fiscal capacity is that it does not relate to the real world of what provincial or state governments actually tax, but rather to what they potentially have available to tax. Thus, in the real world, provincial governments obtain large revenues from oil and gas but not from iron and coal, from alcoholic beverages but not from coca cola, from tobacco and lotteries but not from candy and television, from gasoline but not from electricity, from real property but not from personal property. The RTS recognizes these differences because it determines fiscal capacity by taking account of the actual taxing practices of provinces and local governments. These practices are designed to capture economic rents wherever they exist and to take advantage of the spending priorities of society by taxing most heavily those goods and services for which there is a relatively inelastic demand. Since macro concepts of fiscal capacity do not recognize these distinctions, they neglect the uneven provincial distribution of many of the things that are taxed heavily and do not provide a sensitive measure of fiscal capacity.

The advantage of the RTS can be stated in another way. The RTS provides a direct measure of the fiscal capacity of governments whereas alternative measures of capacity relate to people or to the economy as a whole. These alternatives are useful for many purposes, but it must be questionned whether they are appropriate for determining the amount of transfer payments that go to governments.

HOW THE CANADIAN RTS OPERATES

The Canadian RTS has been designed to take account of whatever elements of income, consumption, wealth or economic rents are taxed by the provinces. It does this by taking account of virtually all revenues from own sources that are derived by any of the ten provinces including their local governments. These provincial-local revenues are classified into separate categories for each type of tax, or group of related taxes, and a distinctive measure of fiscal capacity or "tax base" is then defined for each type of tax. At the present time we have 33 tax groupings, or "revenue sources" as we call them, with a distinctive measure of tax base for each such source.

In calculating equalization entitlements for any given fiscal year we apply the RTS, as defined, to each of the 10 Canadian provinces. This is done by establishing the average provincial tax rate for each revenue source and by applying this standardized rate to a standardized tax base estimated for each province for that source from a common statistical series. The resulting standardized yields of each province for the 33 revenue sources are then summed and compared on a per capita basis with a prescribed per capita standard that is deemed necessary to finance a reasonable level of public services. Where any province's total per capita yield from this system is less than the prescribed per capita standard, it has an equalization entitlement equal to the amount of its per capita shortfall from the standard multiplied by its population. You will note that the entire calculation is based upon standardized data and hence the level of taxes or "tax effort" of an individual province has virtually no bearing on the amount of its equalization entitlement.

It may be helpful to you if I were to categorize the 33 revenue sources which make up the present RTS in Canada. These are as follows:

- 2 income taxes, consisting of personal and corporate income taxes;
- 10 consumption taxes, consisting of general sales taxes, tobacco taxes, gasoline taxes, diesel fuel taxes, taxes on spirits, taxes on wine, taxes on beer, race track taxes, revenues from lotteries and taxes on insurance premiums;
- 3 taxes on property or assets, consisting of taxes on corporation paid-up capital, succession duties and property taxes;
- 12 categories of natural resource revenue consisting of conventional "new oil" (essentially, light oil discovered after December 31, 1980), conventional "old oil" (essentially light oil discovered on or before December 31, 1980), heavy oil, mined oil (essentially tar sands oil), domestic natural gas, export natural gas, oil and gas land sales, miscellaneous oil and gas, potash, other revenues from metallic and non-metallic minerals (with sub-categories for coal, uranium, iron, asbestos and all other), forestry and water power rentals.
- 6 other categories, consisting of motor vehicle licences, (with separate categories for commercial and non-commercial vehicles), health insurance premiums, payroll taxes, miscellaneous taxes and revenues (including revenues from fines, fees, licences and sales of goods and services) and federal revenues from certain taxes that are shared with provinces.

You will, I think, find this range of taxes very comprehensive and probably quite comparable with the range of taxes levied by state and local governments in the United States. The only major category of own-source, provincial-local revenue which is missing is revenues from interest and dividends.

A separate measure of fiscal capacity or tax base is defined for each one of the 33 revenue sources. Each measure used for a revenue source should be typical or "representative" of the tax structure actually used by those provinces that levy the tax falling within that source. The definitions of a tax base tend to be elaborate and technical. For this reason they are set out in regulations under the legislation governing equalization.

I can summarize them as follows:

- For income taxes, bases are derived from taxable income data coming primarily from the federal income tax system.
- For consumption taxes, bases are derived from data on the volume or value of those goods and/or services from which revenues are obtained.
- For taxes on property or assets, bases are derived from data on the value of such property or assets.
- For levies on natural resources, bases are derived from data on the volume or value of production of the natural resource from which revenues are obtained.

You may be particularly interested in the Canadian experience in administering an RTS. As noted, this experience now extends over a period of 16 years. The equalization program is one element of Canada's federal-provincial fiscal arrangements and a long tradition, going back to World War II, has been established of renewing these arrangements every five years. As a consequence, the original RTS established in 1967 was thoroughly reviewed in 1972, and there were further, increasingly extensive reviews in 1977 and 1982. The 1982 review is, in fact, just now in its final stages. Each of these reviews of the RTS has been conducted by the federal government in consultation with the ten provinces. The consultative process has been undertaken by a committee of senior officials from the federal government and the provinces. All provinces have participated in the work of the committee, including those provinces that do not qualify for equalization. The committee work has resulted in numerous suggestions from provinces for changes to the RTS and many of these suggestions have been accepted by the federal government. The work has, in general, been remarkable for the degree of harmony achieved. More generally, the equalization program itself has not been a source of federal-provincial friction, or of friction between provinces that receive equalization and those that do not receive it.

The decisions to be taken have, however, often been difficult owing to the increasing complexity of provincial taxes and the problem of finding statistical data which will reflect the actual taxing practices of provinces and do so on a uniform basis. Problems that have had to be dealt with include: (i) the treatment of provincial tax credits, (ii) the treatment of the earnings of provincially-owned business enterprises, (iii) the varying levels of economic rent associated with different resources and with different deposits of any given kind of resource, (iv) the effects of long-term contractual arrangements on fiscal capacity, (v) the absence of relevant statistical data and (vi) the difficulty in some cases of establishing what particular structure for a given tax can be regarded as "representative" of widely varying structures imposed by the ten provinces. Solutions of one kind or another have been found for all of these problems; while they are not always ideal they have generally been accepted as reasonable.

EXPENDITURE NEED

Before concluding, I should return to the matter of interprovincial differences in respect of expenditures, or as we sometimes say, in respect of "expenditure need". There is little Canadian experience in the measurement of such differences and what you in the United States could learn from us in this general area is limited. However, I would like to make three observations on the basic issue of the relevance of interprovincial differences in expenditure need and on how these differences might be measured.

(1) Unadjusted, raw data suggest that, on an overall basis, per capita disparities among Canadian provinces are very much less, and therefore very much less significant, on the expenditure side of government accounts than on the revenue side. This would not be true, of course, for many individual categories of expenditure but is plausible for expenditures as a whole.

(2) The differences which exist among provinces in respect of expenditures have two basic causes.(1) First, there are differences in average per capita needs for public services. Second, there are differences in average unit costs of providing public services. Most economists would agree that there is a valid argument to be made for taking account of differences among provinces in needs for services. However, some economists contend that the argument for taking account of differences in unit costs is weaker because it would tend to support high-cost government operations as against low-cost operations and this would not contribute to the overall efficiency of the public sector or of the economy as a whole.

(3) Interprovincial disparities in respect of revenues and expenditures are, by and large, independent of each other. It is, therefore, feasible to operate an RTS without taking account of differences among provinces and local governments in respect of expenditures. However, adoption of the RTS does not negate the possibility of taking interprovincial or interstate differences in expenditures into account. If one wished to take account of interprovincial disparities in expenditures, the most appropriate way of doing this would be by constructing a "Representative Expenditure System" which could then be superimposed on the Representative Tax System. The two systems would parallel each other in structure. Whereas the RTS breaks total provincial-local revenues down into revenue

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(1) In addition, of course, there are differences among provinces in actual levels of public services as a result of conscious choices by political decision-makers but differences of this kind are not relevant to the standardized measurement of disparities.

sources, the RES would break total provincial-local expenditures down into expenditure functions. And whereas the RTS depends upon a measure of fiscal capacity or tax base for each revenue source, the RES would depend upon a measure of expenditure need for each expenditure function.

CONCLUSIONS

1. Canada has used an RTS in its Fiscal Equalization Program since 1967. By the time the present program expires in 1986, the system will have been in operation for 20 years. The system has worked well and has contributed to public confidence that a program which is intended to identify and assist needy provincial governments does so on a fair and equitable basis.
2. The RTS is the most sensitive and fair measure of the relative revenue-raising capacities of regional governments and of changes in these capacities over time. While certain macro-economic measures of fiscal capacity are also available, they do not relate to governments per se and are therefore less appropriate measures of differences in the capacity of governments to raise revenues.
3. The RTS does not take account of differences among regional governments in respect of expenditure needs. However, differences among governments in respect of revenues and expenditures are essentially two separate matters. The use of an RTS in an intergovernmental transfer program would not inhibit separate steps being adopted to take account of differences among governments in respect of expenditure needs.

Douglas H. Clark

Senator DURENBERGER. We next have a panel of representatives from the local public interest groups. First, Mr. Robert Orth, from Ramsey County, Minnesota, representing the National Association of Counties; second, Mr. John Rousakis, the mayor of Savannah, Georgia, on behalf of the United States Conference of Mayors; then the president of the National Association of Towns and Townships, Mr. George Miller of Illinois; finally, Chris Lindley, city councilman, Rochester, New York, on behalf of the National League of Cities.

Let the record show that each of these folks has a written statement which will be made a part of the record, and we will go in the order of introduction with your presentations.

Bob?

TESTIMONY OF ROBERT ORTH, LEGISLATIVE AND INTERGOVERNMENTAL RELATIONS CHAIRMAN, RAMSEY COUNTY BOARD OF COMMISSIONERS, ON BEHALF OF THE NATIONAL ASSOCIATION OF COUNTIES; JOHN P. ROUSAKIS, MAYOR OF SAVANNAH, GA., ON BEHALF OF THE U.S. CONFERENCE OF MAYORS; GEORGE MILLER, PRESIDENT OF THE NATIONAL ASSOCIATION OF TOWNS AND TOWNSHIPS; AND CHRIS LINDLEY, CITY COUNCILMAN, ROCHESTER, N.Y., ON BEHALF OF THE NATIONAL LEAGUE OF CITIES

Mr. ORTH. Mr. Chairman, thank you. For the record, I am Robert Orth, Rural Ramsey County Commissioner in Minnesota. I am chairman of the Legislative and Intergovernmental Relations Subcommittee for the Ramsey County Board. I am here today to speak to you on behalf of the membership of the National Association of Counties.

I come before you to present NACo's view concerning the renewal of the general revenue sharing programs and our reactions to the various proposals for reauthorization that have been advanced. It is unnecessary, I know, to convince you, Mr. Chairman, of the importance of this program to local governments. On all levels of government we are confronting difficult times, and general revenue sharing has played a vital role in allowing the counties to maintain a reasonable level of service delivery in the face of the cutbacks and the negative impacts of the recession.

It is a great relief to the counties of this Nation that Congress appears to recognize the importance of revenue sharing to the fiscal health of local jurisdictions, as evidenced by the introduction of several bills for renewal of the program. Some of these bills would provide for a continuation of revenue sharing for 3 years in its current form, and others, such as S. 700, a bill you introduced, Mr. Chairman, authorize sweeping changes in the program.

It is your bill, Mr. Chairman, that would profoundly alter the structure of general revenue sharing by permanently authorizing the program and changing not only the allocation formula and constraints, but the method by which revenue sharing is funded.

It is a very ambitious and interesting proposal that attempts to make the program more responsive to State and local disparities in fiscal capacity.

Let me say at the outset that many of the changes you propose are changes that the National Association of Counties advocates in its revenue sharing policy. Our policy calls for a permanently authorized program funded from a fixed percentage of the Federal income tax base. Your proposal would achieve this by permanently authorizing revenue sharing on an entitlement basis and funding it through annual appropriations to a State and local fiscal assistance trust fund of 4 percent of the Federal income tax receipts.

As Federal income tax receipts grow over time, the general revenue sharing allocations to State and local governments would, therefore, increase, preventing the value of revenue sharing dollars from being eroded by inflation and allowing State and local government to participate in a systematic way in the growth of Federal revenues.

We feel that this approach is consistent with the original intent of Congress in establishing general revenue sharing. Furthermore, it would provide local governments with a sense of predictability in their budgetary process, a sense, Mr. Chairman, I might add, that I have not had the last 4 years as a county commissioner.

The second element of your proposal that is in agreement with NACo policy is the participation of the States in general revenue sharing. NACo believes that the States need general revenue sharing in order to fulfill their service responsibilities and deal with these fiscal dilemmas without overburdening local governments.

As you can see, there are several elements of S. 700 that correspond closely to changes in the general revenue sharing program that are advocated by NACo. However, there are also points of disagreement. The first of these relates to the allocation formula changes contained in S. 700. The changes your bill proposes generally provide for a distribution of revenue sharing funds to States on the basis of their relative fiscal capacities as measured by their potential performance under a representative tax system and for a distribution of revenue sharing funds to local governments on the basis of population, tax effort, and relative income.

Under the proposal, no local government would receive fewer dollars than it now receives.

Our problem, however, is, first, that we have no figures in front of us, Mr. Chairman, that would tell us what reaction or what effect these changes in allocation would have; second, the detiering process contained in S. 700 may cause some unnecessary competition between local governments for those revenue sharing dollars, and I might also add that it could possibly penalize any local government trying to produce cost effective programs. By maintaining a high unit cost rather than measuring the effectiveness and benefit of your programs, you will be rewarded under the new proposal.

The changes in general revenue sharing formula constraints that are proposed in S. 700 may also affect some county governments in the out-years of the program.

I would like to move now to another aspect of your proposal that troubles you, and that is your plan to finance the State and local fiscal assistance trust fund with Federal individual income tax receipts obtained through limiting the deductibility of State and local taxes.

It is our feeling, Mr. Chairman, that this could have a severe effect on the ability of local government to raise revenue and to control, within reasonable limits, their taxing limitations. Perhaps to make that clear, Mr. Chairman, I have found in campaigning that when I go door to door and talk to my constituents, if I mention raising personal income taxes, they slam the door in my face. When I mention raising property taxes, they go for their gun.

We believe that limited deductibility would increase taxpayer resistance to taxes at the local level and hamper our capacity to raise revenues. We are aware of the economic studies that you have quoted in defense of this proposal which indicate that if a taxpayer's income is reduced by some amount, that there is still a willingness to pay an increase in local taxes as long as there is not a dollar for dollar comparison. And I do not mean to imply that NACo is insensitive to the Federal need to balance the budget. We realize that if funding for the general revenue sharing program is to be increased as substantially as you have proposed, a source of funds for that increase must be found.

However, we would urge that you look to sources other than the limitation of deductibility because the negative impact that this may have at the State and local level.

I would say that in summary, our overriding concern regarding the structural changes to revenue sharing that have been imposed in S. 700 is not whether we would create winners and losers among the counties or between counties and other local governments but, rather, whether the changes they would effect would generate political obstacles to the timely reauthorization of this program. We feel that the sweeping changes proposed under S. 700 could divide the congressional supporters of the current program.

The time required to overcome such divisions might be too great to permit speedy reauthorization of revenue sharing. Therefore, we respectfully submit, Mr. Chairman, that a longer time period than the 1 year now available to us is necessary to responsibly evaluate your proposal and take steps to implement it, if that evaluation indicates that the changes it contains would substantially improve the structure of the general revenue sharing program.

The National Association of Counties stands ready to work with you in all efforts to increase the effectiveness of general revenue sharing, and we appreciate your continuing interest in the status of State and local governments.

Thank you, Mr. Chairman.

Senator DURENBERGER. Thank you very much. I guess, John, you are next on the list.

Mr. ROUSAKIS. Thank you, Mr. Chairman. It is good to be with you again. For the record, I am John Peter Rousakis, mayor of the city of Savannah, Ga., and cochairman of the general revenue sharing task force for the U.S. Conferences of Mayors.

Mr. Chairman, thank you for this opportunity for the U.S. Conference of Mayors to testify on the renewal of general revenue sharing, a program of considerable importance to mayors around the country.

The revenue sharing program has been an extremely important source of flexible funding for local government over the last decade. Renewal of the program is vital to the continued viability of cities and to their continued ability to provide important services to their citizens.

Let me point out, Mr. Chairman, that without it, the cost to local government would have been devastating. The tax increases or service cuts or a combination of both would immediately take place without the revenue sharing program.

The revenue sharing program, first enacted in 1972, has long been supported by Republicans and Democrats in the Congress. It is a truly bipartisan effort to address the fiscal problems and revenue constraints of local governments—an effort consistent with nearly everyone's idea of a sound Federal relationship.

The program allows local governments wide latitude to determine their most pressing needs and allocate their revenue sharing funds correspondingly. At the Federal level, there is almost no overhead—less than 2 percent—and fewer than 100 Federal employees to administer what is the largest Federal grant program, a total of $4.6 billion allocated to 39,000 units of government. This is truly an admirable and unique nonbureaucratic record.

Local governments are in desperate need of a continuation and expansion of the revenue sharing program. You are all familiar with the cuts in Federal aid which we have had to absorb in the last 2 years, a total decline of nearly $40 billion in Federal assistance to State and local governments. Moreover, now that States are facing large deficits, it seems inevitable that State assistance to cities will decline substantially in fiscal year 1984.

City revenues are further undermined by the last 2 years of declining property values, which has shrunk the property tax base in many areas, and high unemployment which further reduces city revenues.

While many cities have pushed for increases in tax rates or new taxes, particularly user fees, to offset these revenue shortfalls, these increases have proven difficult. Many cities are now faced with property tax limitations or strong voter resistance to tax rate increases. Consequently, the only option available to these communities has been massive cuts in expenditures and services.

At the same time, cities are faced with rising service demands. The large number of long-term unemployed, hopeless and hungry families whose needs are no longer being adequately addressed by the Federal Government have resulted in increased city expenditures for emergency assistance, health care, and other programs for the poor. Moreover, important infrastructure projects have been postponed to the point where needed repairs are extremely costly, far beyond the financial ability of most cities.

And even basic services for police and fire protection and sanitation have been curtailed with substantial layoffs of personnel by cities.

Revenue sharing is extremely important to cities in meeting important needs for infrastructure projects, basic services, and social service programs.

Mr. Chairman, the Conference of Mayors commends you for your leadership in formulating important revenue sharing legislation. Like you, the Conference of Mayors urges that the revenue sharing program be renewed in a timely fashion. Many local governments still use a July 1 fiscal year, which means they must know soon how much they can expect to receive in general revenue sharing funds. In order to provide greater certainty in the program in the future, we support the renewal of revenue sharing on an entitlement basis for a period of 5 years, or, ultimately, on a permanent basis.

In addition, we support an increase in the revenue sharing program to compensate for inflation over the past decade. As you know, the revenue sharing program has not been increased since 1972 except for a small token rise in 1976.

Although S. 41, the first revenue sharing bill you introduced, does not provide an increase in funding, we have been extremely supportive of your efforts to secure cosponsors. We appreciate your efforts and the significant Senate support for the bill which has been forthcoming.

We interpret this as a sign that the Senate is determined to reenact revenue sharing and to do so quickly.

With respect to S. 700, which would expand and reform the revenue sharing program, the Conference of Mayors is generally quite supportive. We appreciate the thought which has gone into formulation of the bill and your concern that consideration of this measure not hold up renewal of the program.

It probably comes as no surprise that the Conference of Mayors strongly supports expansion of the program as proposed in the bill, as well as efforts to link the program to a set percentage of Federal income tax revenue. This moves us back to the original concept of revenue sharing as envisioned in the 1960's. Such a linkage would allow State and local governments to share in the benefits of future economic growth.

In the next paragraph, Mr. Chairman, while I would prefer to remain neutral on the position of the states, it is the Conference of Mayors' policy position and the conference applauds the inclusion of a State role in the revenue sharing program. The Conference of Mayors thought that it was a mistake to remove the States from the program when revenue sharing was reauthorized 3 years ago since a significant proportion of State revenue sharing funds were used to assist local governments.

The reason for my qualifying that statement, Mr. Chairman, and the reason that I would prefer to remain neutral on it is that most cities did not share in revenue sharing to the States. While many of my colleagues are here making a case for the cities, before any final action or consideration is made on including the States, the Governors should also make their case before you.

You may find that they have other priorities and that revenue sharing is not one of them.

Mr. Chairman, I wish I could comment on the formula changes proposed in S. 700, but the Conference of Mayors has not had time to consider your specific recommendations and currently has no policy on any changes in the revenue sharing formula. It has been the position of many mayors that a change in the formula is undesirable because of the political fights which formula changes generate and the likely delay in reauthorization which it could engender.

Other mayors would, I am sure, like to see some alteration in the formula which would concentrate additional funds in fiscally distressed, high tax effort areas. Certainly, the rather substantial increase in funding which is proposed in your legislation, along with the hold harmless provisions, may mitigate the opposition to a formula change.

With respect to your proposed restriction on the current deduction of State and local taxes, the Conference of Mayors is concerned that such a change, however progressive and equitable it may seem, will have adverse effects. We fear that if adopted, it will increase taxpayer resistance to State and local taxes, especially the resistance of high income and business taxpayers. Moreover, to the extent that local governments have progressive tax systems, the greater the difficulties are likely to be.

Second, we are concerned that opening up a discussion on the current deductions will set up an undesirable precedent, and that the Finance and Ways and Means Committees may seek further restrictions on the deduction now or in future years. Our experience with the tax exemption for municipal securities is illustrative in this regard.

Once Congress began to restrict the tax exemption, further restrictions were forthcoming, and we have had to refight the battle every year.

Mr. Chairman, thank you for this opportunity for the Conference of Mayors to testify on general revenue sharing. It is a program of vital importance to local governments, and we are appreciative of your strong support and leadership to secure its reenactment and expansion. We look forward to working with you and the members of this committee to design a revenue sharing program that adequately meets the urgent needs of our cities and our urban residents.

I thank you very much, Mr. Chairman.

Senator DURENBERGER. Thank you, very much.

George Miller, you are next.

Mr. MILLER. Thank you, Senator.

For the record, my name is George Miller, and I am president of the National Association of Towns and Townships. I am also executive director of the Township Officials of Illinois. Our National Association of the Board of Directors serves local government officials from over 13,000 small communities across the country.

I want to thank you for the opportunity to be here this morning.

Reauthorization of the general revenue sharing program in its current form is NATaT's major legislative priority in 1983 for several important reasons: Town governments need general revenue sharing funds to help offset the extreme limitations of the real property tax, a burden that is only partially alleviated through other taxes, charges, and in-kind contributions.

Another major constraint facing our members is that their taxing authority is, in many cases, severely limited by State constitutions or statutes. Revenue sharing helps bridge these gaps to a great extent.

An important plus of the revenue sharing program is that it is flexible enough in design to enable each township to use the funds to meet its most pressing real needs, an important factor in an economic climate where financial resources are depleted. Additionally, the minimum of paperwork and regulations in the GRS program guarantees funds to local governments that would otherwise not have the professional capacity to identify and compete for Federal aid.

These, Mr. Chairman, are some of the major reasons why America's towns and townships see revenue sharing funds as such an important resource.

Recognizing that testimony alone is not enough to demonstrate the support for renewal of this program, our national association has conducted a survey of actual use of revenue sharing moneys among its members.

I am pleased to be able to report that our national office has received, as of today, approximately 5,000 responses from member town, including more than 900 from townships in Minnesota.

While half of these have been tabulated, they do provide a clear understanding of the importance and use of revenue sharing funds to small communities.

I am not going to report in great detail on the findings of NATaT's nationwide survey, but with your permission, we would like to submit for the record a table that does provide more detail, particularly for those towns of under 10,000 in population.[1]

Senator Durenberger. It will be made a part of the record.

Mr. Miller. Thank you.

On the average, revenue sharing funds constitute about 15 percent of the total budget of the localities that responded to our survey. Over 60 percent stated that revenue sharing moneys are the only Federal funds that they receive directly. Sixty-five percent of the respondents to the NATaT survey indicated they would have to raise taxes if their funds were eliminated. Nearly half in Illinois are now attempting to raise their millage limit and said they would have to cut back or eliminate programs entirely.

Survey respondents were asked to indicate from a variety of sources what the actual uses of their GRS funds were. There were 18 general categories. The responses were amazing and innovative. Townships provide everything from ambulance services to programs for youth.

We hope the information will be helpful to the Senate as it deliberates the future of the revenue sharing program. The response to our national survey demonstrates that towns and townships are spending their general revenue sharing funds in a responsible manner consistent with congressional intent.

For these reasons, we enthusiastically endorse reauthorization of the program, and we are in full support of your bill, Senator, S. 41.

The NATaT Board of Directors recently adopted some additional policy concerning general revenue sharing that I would like to mention briefly. With respect to bringing States back into the program, we do support a State revenue sharing program as long as funds allocated for local government share are not used to finance the State portion of the program.

The association favors the reauthorization of the program for at least 3 years but preferably a longer period. We do not support the administration's concept of combining the entitlement portion of the community development block grant with the general revenue sharing program.

The NATaT Board of Directors firmly believes that this legislative proposal might possibly confuse the original intent of the general revenue sharing program and would be harmful to local governments.

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[1] See p. 180.

On another matter, we do not see any need to make any changes in the current formula. While the formula is not perfect, in our view, it is fair and equitable, particularly given the enormous diversity which exists among the over 39,000 eligible recipients.

Despite NATaT's strong support of the current formula, the association does keep an open mind about proposals which are intended to improve the program such as your bill, Mr. Chairman, S. 700.

Before I address the specifics of this initiative, I would like to provide NATaT's perspective on the current formula.

The current formula incorrectly assumes that the only way for local governments to finance needed services is by levying certain taxes. The assessment of user fees, in-kind contrbiutions and specific assessments, for example, are excluded entirely in the entitlement computation process. Nor does the formula take into account that part of the local government work force which receives no pay at all for services rendered to the locality.

To summarize, Mr. Chairman, the current formula is deficient and does not reflect the locality's use of special fees or user charges, use of volunteer labor and other alternative mechanisms that may be used by local governments, particularly rural jurisdictions, to provide public services.

As a result, the formula for the general revenue sharing program tends to overlook the unique character and special nature of the smaller units of government.

It is our opinion, however, that these limitations do not warrant changing the formula. During the past 10 years, the Congress has discussed the possibility of altering the formula on several occasions but has concluded that difficulty of designing a formula for so many local governments would make it impossible to create one that is perfect.

The current formula, though, comes pretty close.

With this information as background, Mr. Chairman, I would like to address your request for our association's views on the formula changes proposed in S. 700, the State and Local Fiscal Assistance Act of 1983.

I would like to preface my remarks by stating that NATaT policy on the general revenue sharing program, to date, does not encompass all of the major provisions of S. 700. Consequently, my comments are presented with some qualifications.

NATaT supports, without reservation, your efforts to create a permanent revenue sharing trust fund and bring the States back into the program according to a formula based on fiscal capacity. The association also supports funding the increased costs with increased revenues from a fixed percentage of the Federal individual income tax.

For the short term, however, we support this funding mechanism only as long as the current $4.56 billion for the local share is funded from general revenues.

Our greatest concern about the aforementioned issues is that a protracted discussion on changes in the program may endanger its chances for renewal.

A delay in the reauthorization process could provide critics of the program with an opportunity to defeat its reauthorization.

The importance of the program to towns and townships cannot be overstated. So while strong support exists for the merits of your proposal, our outlook is tempered by the specific knowledge that towns would experience extreme fiscal distress if the program is not renewed.

Our board of directors views with reservation the modifications S. 700 would make to the current three factor intrastate formula. In our opinion, any attempt to modify the formula might well result in unforeseen inequities. In particular, I refer to the provisions that would detier the intrastate formula, adjust the floor and ceiling for entitlements and replace the existing 50-percent budget constraint with a variable budget constraint, despite the fact that a hold-harmless provision is included to guarantee that each local government would continue to receive the same amount of funding as it does at present.

Mr. Chairman, this concludes our remarks, but on behalf of our board of directors, I want to thank you and the entire subcommittee for providing us with the opportunity to share our views on the revenue sharing program and its renewal. I personally want to thank you for your long dedication and devotion to promoting local government. We appreciate it.

Thank you very much.

Senator DURENBERGER. Thank you very much. We'll have a brief recess.

[Brief recess.]

Senator DURENBERGER. Mr. Lindley, you may proceed.

Mr. LINDLEY. Mr. Chairman, I am Chris Lindley, a council member of the city of Rochester, N.Y., a member of the National League of Cities' Advisory Board, and a member of the NLC's task force on revenue sharing. I am appearing today on behalf of the National League of Cities. I have a statement which I will not read. I know you have already read it, and you have expressed to me your qualified enthusiasm.

Senator DURENBERGER. With that qualification, it will be made part of the record.

Mr. LINDLEY. Thank you.

Reauthorization of general revenue sharing is clearly the No. 1 priority for American cities this year. We believe the need to act upon this expeditiously is underscored by the fact that over 50 percent of the cities which the National League of Cities recently surveyed have fiscal years commencing on July 1. Further delays would mean that we are really speculating in Federal legislative futures in formulating our budgets for the coming fiscal year.

I would also like to insert in the record two studies which the National League of Cities recently completed: one of fiscal conditions in fiscal year 1983, the second a survey of member cities on the importance of general revenue sharing, how it has been used, and why it is so critically important to have general revenue sharing reenacted.

Senator DURENBERGER. Without objection, they will be made a part of the record.[1]

Mr. LINDLEY. Now let me turn to the specific recommendations of the National League of Cities with respect to the general revenue sharing. First, we recommend a 5-year extension of the program, assuring local governments that this essential aid will be available for a reasonable period. Second, we recommend an increase in funding. General revenue sharing funding has deteriorated in terms of real value to municipalities by at least 50 percent. Let me share with you some statistics I gleaned from our own budget director yesterday.

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[1] See pp. 207 and 226.

Our total entitlement, because of cuts in State taxes and despite escalating local taxes, has decreased from 1972 to 1983, as a percentage of our operating budget, from 6.7 percent of all revenues to 2.1 percent. That is on top, Mr. Chairman, of a reduction in the number of full time positions funded from 3,900 to 1,320. I think that makes very vivid a determination of the net worth of general revenue sharing to its recipients.

We believe that a 20 to 25 percent increase would be a modest step toward returning to the level of Federal commitment originally made by the Congress in 1972–73.

Third, we believe that the current formula should be maintained, as well as all existing program and reporting requirements.

Fourth, we strongly support the retention of the entitlement feature of general revenue sharing.

Let me just add a few comments. I am not in a position to speak for the National League of Cities on some of these issues. I want to say at the outset, personally, how much I have admired your commitment to bringing greater equity to the entire governmental system. I have here the speech that you gave in Detroit in December of 1981, which, it seems to me, expresses that as well as anything I have heard.

On the question of State participation, the National League of Cities has not taken a position. NLC believes that it is incumbent upon the Governors to find out what their priorities are. If I can just make a personal comment, I do not know why you should include any State whose legislature has passed a Federal balanced budget amendment; that, it seems, is something that we could take into the formula if you are going to include the States.

Senator **DURENBERGER**. You sound like a Congressman.

Mr. **LINDLEY**. Do you support that, Mayor Rousakis?

On your proposal, Senator, with respect to taxes, I have a real fear that this will sharpen local resistance to local tax levies and, therefore, result in greater dependence of cities on State and Federal revenue.

With respect to the severance tax issue, our Finance, Administration, and Intergovernmental Relations Committee met last October to assess this question. The underlying issue is a fundamental issue of equity. Should you receive effort for taxes which are levied on people outside your jurisdiction? This is part of the larger tax exportation issue. A number of people have raised some very serious questions about other tax exporting devices, as well as minimal severance taxes.

Personally, I think we should look at tax exporting comprehensively. It may well be that minimal severance taxes may not be the only element that should be taken into consideration.

In 1979–80, when I had the pleasure of chairing the NLC task force for the reenactment of general revenue sharing, we supported detiering. We supported raising the maximum entitlement from 145 to 175 percent of State per capita income. That position was not renewed by the board of directors of the National League of Cities this year. I think the reason is, Senator, we are afraid that if we get involved in issues of formula changes, we will end up with no revenue increase whatsoever.

Let me just conclude by saying this: In March, Congressman Brooks came to NLC and expressed his views on GRS very vividly. He made a very fine speech; the conclusion was wrong, but a fine speech. He went through and looked at the underlying arguments in favor of general revenue sharing in 1972 and 1973 and tried to show why they no longer pertained today. He said, "You are left with only one argument, expressed in four simple words: We need the money." I cannot think of any better argument than that. We need the money, and we cannot afford the luxury of sitting around and debating endlessly over the question of how to divide that money. If we do, we will get nothing.

Thank you very much.

Senator **Durenberger**. Thank you very much for your testimony, all of you. I will try to keep my questions very brief.

Yesterday we spent some time with experts who have not been elected to office but who have been dealing with the subject of revenue sharing for a long time, in examining the roots of revenue sharing and taking a look at whether those roots are still applicable today. I think despite what some of you stated in your statements, there are different reasons today for revenue sharing. Though revenue sharing has an intergovernmental fiscal mechanism that is still the terrific mechanism that everybody said it would be, there are different reasons today to be using it, which means certain aspects of the program should change to reflect these new reasons.

Let me first ask about the modifications in the local GRS formula that we have proposed. We did not invent them. They came out of recommendations from GAO and Treasury. We have been through those proposals, as you pointed out, in 1977 and 1980. At the time, one or more of you had a position in favor of them.

Today, those positions sound like they may be altered a bit. But let's assume that the amount of money can be raised—as I recommend in S. 700—to the point where not only does it reflect the inflationary problems but also encompasses a "hold-harmless" provision. That takes us up from $4.6 to $5.9 billion.

If those two things are incorporated into it, is there anything that any of you or your associations believe inherently wrong about changing a system in which cities almost identical in population and income and tax effort are treated very differently because they happen to be in different counties? Changing that system to one that treats them as cities rather than part of the county?

Do you have a reaction to that?

Mr. **Orth**. Mr. Chairman, it is still difficult to comment, not knowing the figures. If I may——

Senator **Durenberger**. The reality, Bob, is—and perhaps I am not going to give you the kind of figure that you want—but testimony we had yesterday from GAO indicated that the cost, just of holding local governments harmless under detiering, is somewhere in the neighborhood of $200 million. But a large part of that $200 million falls on a relatively few number of very well off units of local government. It is not uniformly spread, so the political consequences are few in number, but they are fairly large.

Mr. **Orth**. Mr. Chairman, the point I was going to make was that—and to quote the mayor of the principal city in my county, Mayor Latimer; that is, "If it ain't broke, don't fix it."

I don't know why moving to a municipal base or tiering, if you will, rather than a county area tiering is inherently any better than what we are now doing.

I think we could explore it, because I realize that there are significant cases—although they might be isolated—where an inner core city is being badly hurt by the tiering system.

In my county, that isn't the case, and quite frankly, leaving it at the county level creates more equities within Ramsey County than it does inequities, and possibly going to a municipal level would reverse that possibility.

So it is difficult without studying it further to know why one form would be any better than what we are presently doing.

Senator **Durenberger**. Any other comments?

Mr. **Lindley**. My understanding of the impact is it penalizes you for living next to somebody who hasn't got a lot, even though you haven't got a lot. Is that basically the issue?

Senator **Durenberger**. Of tiering?

Mr. **Lindley**. Yes.

Senator **Durenberger**. It penalizes you for living in the same county with others who do have a lot even though you don't have a lot yourself.

Mr. **Lindley**. The issue of equity is one we did try to address, unsuccessfully, in 1979 and 1980. The underlying principle, though, is one that we have generally been responsive to, that is, there ought to be a greater priority for the city.

Senator **Durenberger**. John?

Mr. **Rousakis**. I support what Chris just said, Senator. There is an inequity there, and it does exist when you have identical cities with identical needs that are getting different amounts of aid because of the county area in which they are located.

I hope after the revenue sharing is reauthorized that we can get into it. We basically support the detiering proposal that you make.

Senator **Durenberger**. The problem may be, in response to that last comment, that you may get a short-term reauthorization of $4.6 billion, but if you were pressing hard to get it up higher, I suspect that we would have to address the detiering issue immediately. And somehow or another, the counties and cities are going to have to reach some accommodation on that issue and decide whether they can trade off the extra money for greater equity.

That is likely to be an issue that we face here in the next 6 weeks or so.

Mr. **Rousakis**. It is getting down to nervous time for me.

Senator **Durenberger**. Wait until September 1.

No, hopefully we won't wait that long.

George, do you have a comment?

Mr. **Miller**. Senator, our feeling is that we don't have enough information to make a well informed decision. We are in the same situation the counties and cities are, but we do feel that under some of the proposals, the small governments would lose proportionately more than urbanized, larger units of government.

Therefore, I must agree with some of the other gentlemen on this panel. Congressman Horton and yourself are perhaps ready to go with a renewal at the current level of funding and then work into the process, and I think we could all agree on that.

Senator **Durenberger**. Thank you.

Mr. **Miller**. "Nervous time" is getting close.

Senator **Durenberger**. The last point deals with a major financing change contained in S. 700.

I am glad that you were all able to be here for the previous testimony on the representative tax system, because I think it was well done, and I don't necessarily want to deal with that issue now unless any of you want to amplify your comments. But I would like to discuss the financing approach that S. 700 uses for State revenue sharing.

First, I'd like to make clear for the record that as the author of S. 700 I did not come to this out of a political science textbook or something. I came to it out of the Finance Committee last year in exploring the trend in this country toward a flat rate tax and a broadened tax base.

The whole issue of deductibility is heating up again. It has never gone away, only cooled from time to time. If you go way back to 1917, that was the year we got rid of the deductibility of Federal income taxes from the Federal income tax. In 1943, we got rid of the deductibility for all Federal excise taxes. In 1964, we got rid of the deductibility for State and local taxes other than gasoline. In 1978, we got rid of the deductibility for State and local gasoline taxes. Last year we had before us a proposal to get rid of deductibility for State sales taxes.

Now we have before us a bill, Bill Bradley's and Dick Gephardt's proposal, for a so-called flat rate Dick Gephardt's proposal, for a so-called flat rate tax which gets rid of the deductibility for both sales taxes and personal property taxes.

Next we're bound to see proposals to repeal deductibility for State income taxes, and that will leave you with only the real property tax qualifying for the Federal deductibility.

Common sense tells you that the removal of deductibility on a selective basis skews tax policy in the direction of taxes that still have deductibility. That means that the incentives are going to be on raising the real property tax, which I hope to God is something that nobody representing local government wants this intergovernmental system to do.

Yet there's a great public demand for a flat rate tax and a broadened tax base, and I think both are coming. So the real issue here is whether or not people at the State and local government level can get out ahead of it and, in some way, tie any changes in deductibility to the concept of revenue sharing.

The States represented here today have a fairly substantial stake in whatever happens. If we eliminate the sales tax deduction, Illinois loses about 22 percent of the total deduction. Georgia loses 17; New York only loses 13.6, but New York is the biggest sales taxpayer in the country, or at least the largest deduction in the country, at $559.86 million.

I really understand when you look at something that says we are only going to take the first 1 percent of AGI, that you say, "Yes, Senator, but by that same routine, it used to be 1 percent on the medical deduction, and you took it to 3, and then last year you took it to 5 and you are going to eventually eliminate it."

That is the point at which you have to have some strength in the intergovernmental fiscal system. Then you go and you look at what is to hold it back, and you see State and local taxes deducted as a percentage of AGI. For taxpayers in 1979, New York was the highest in the country in terms of taxes deducted as a percent of AGI at 12.6 percent; Wyoming was the lowest at 3.1 percent, so right off the bat, the Wyoming taxpayers lose one-third of the bennies. But New York doesn't hurt too much. The U.S. total is at 7.6. Georgia is at 6.7; Illinois is 6.5; Minnesota, or course, is up at 10.3 right behind New York and Massachusetts. We have got a long way to go for these States but not for Texas and Wyoming at 3.1 percent. Anyone who has experienced formula politics in Congress should recognize that it is impossible to treat States very differently. So the fact that there are a substantial number of States with total deductions as a low percentage of their AGI sets a natural ceiling on how high Congress will push the floor deduction.

The other principal point from the standpoint of those of you who say the door is going to get slammed in your face or the shotgun is going to get pulled out is the fact that the deductibility limit is designed as a floor, not as a cap, so that every additional dollar of sales tax, property taxes or income taxes that you levy is not subject to the elimination of deductibility. Each one of the new taxes is deductible. The marginal dollar is still being deducted at the top. The restriction is at the bottom.

Having said that, my basic question, because all of you have to do the tax levying out there, is why you think that that kind of a proposal is, in some way, going to make it more difficult to raise taxes at either the State or the local level?

Does anybody want to give a response?

Mr. **Rousakis.** I had trouble following your reasoning with that, Senator, and if I had trouble, I know what my citizens are going to say when I try to explain that proposal to them.

Again, I would have to spend some time, personally, with it to determine to what extent my people would be affected and what taxpayers would be affected and what their reaction to something like that would be.

At this time, I just couldn't comment any further than that.

Senator **Durenberger.** Let me just say, John, it took me from last July to about now to understand it, so I am willing to give you a year, because I need you to convince the good folks of Savannah that it is a good idea. I am certainly not going to be able to sell it here all by myself, because it looks like another "withholding on dividends and interest" type of issue, one that tends to get clouded and over-complicated by controversy.

Mr. **Rousakis.** Right off the top, though, it sounds like something that if it was enacted this year would prompt three newly elected officials to be here next year to talk about it.

Senator **Durenberger.** I just hope we aren't forced into TEFRA II this summer, because the cart is going to get before the horse. If we are back here in July doing TEFRA II, you will get some type of limit on deductibility and, unless you are ahead of it, no GRS in return.

Mr. ORTH. I think I agree with the mayor: That I am sure my successor would like to discuss it with you.

By meaning no disrespect, Mr. Chairman, part of the problem with deductibility is that John Q Citizen doesn't see a lot of difference between Senator Durenberger and county commissioner Bob Orth.

Senator Durenberger levies the taxes that they hate, and Bob Orth levies the taxes that they hate. They aren't very sophisticated in what is gross earnings; what is personal income; what is personal property tax.

They, however, are very aware of the property tax for some rational reasons, some irrational reasons. They don't know why their tax burden is heavier, but they know it is heavier throughout their life now. But when it comes into that one area, they can identify it. They have the little sheet of paper each year, and they have the figures from the year before, and they know it went up.

It is one of the reasons I am supporting our Governor's idea of changing it to a four-payment system from a two-payment system. It will make the load a little easier.

Also, I think it is an emotional or an irrational "A person's home is their castle" kind of thing. They will take the withholding, and they will take an additional raise in FICA, but when you come to that property tax, you are encroaching, you are violating, you are perturbing. It is an extremely difficult tax to use, and it is economically—I disagree with one of your earlier presenters—it is economically not a very good indicator of what your community is like in terms of employment or actual appreciation rather than false appreciation of property.

Senator DURENBERGER. Any other comments on that?

If not, I thank you all very much for your formal and informal presentations.

[The prepared statements of Messrs. Orth, Miller, and Lindley follow:]

PREPARED STATEMENT OF ROBERT ORTH

Mr. Chairman and members of the subcommittee, my name is Robert Orth. I am a commissioner of Ramsey County, Minnesota, and legislative and intergovernmental relations chairman of the Ramsey County Board. It is my pleasure today to appear before a subcommittee whose chairman and members are true friends of State and local government.

I am here today on behalf of the counties that comprise the membership of the National Association of Counties.[1] The member counties of NACo represent 90 percent of our Nation's population and range from small rural counties with populations of less than 5,000 to densely populated urban counties with populations of over one million. These counties provide their citizens with a range of services from maintenance of roads and bridges, to employment and training, to health care, to jails.

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[1] The National Association of Counties is the only national organization representing county government in the United States. Through its membership, urban suburban, and rural counties join together to build effective, responsive county government. The goals of the organization are to: improve county governments; serve as the national spokesman for county government; act as a liaison between the nation's counties and other levels of government; achieve public understanding of the role of counties in the federal system.

I come before you to present NACo's views concerning the renewal of the general revenue sharing programs and our reactions to the various proposals for reauthorization that have been advanced. It is unnecessary, I know, to convince this subcommittee of the importance of this program to local governments. You are aware that we confront difficult times. Since the 1981 Reconciliation Act, counties have sustained over a 15 percent reduction in Federal funding. General revenue sharing has played a vital role in allowing us to maintain a reasonable level of service delivery in the face of these cutbacks and the negative impacts of the recession.

It is a great relief to the counties of this Nation that the Congress generally appears to recognize the importance of revenue sharing to the fiscal health of local jurisdictions, as evidenced by the introduction of several bills for renewal of the program. Some of these bills, such as the chairman's own S. 41, and Rep. Horton's H.R. 616, would provide for a continuation of revenue sharing for three years in its current form at the same funding level. Others would effect changes in various elements of the program, including the funding amount or formula. H.R. 1930, introduced by Rep. Ted Weiss, and S. 700 introduced by you, Mr. Chairman, are examples of this second type of bill. It is clear, however, that the structural alterations to the program that your bill proposes are far more substantial than those proposed in Mr. Weiss' bill. His legislation would make three basic changes: First, it would lengthen the reauthorization period from three years to five; second, it would increase the local share 16 percent from $4.6 billion to $5.3 billion; and third, it would fund States' participation in the program at a level of $2.6 billion. The Weiss bill would make no changes to the revenue sharing allocation formula.

Your proposed legislation is far more sweeping, Mr. Chairman. It would profoundly alter the structure of general revenue sharing by permanently authorizing the program and changing not only the allocation formula and constraints, but the method by which revenue sharing is funded. It is a very ambitious proposal that attempts to make the program more responsive to State and local disparities in fiscal capacity.

Let me say at the outset that many of the changes you propose are changes that the National Association of Counties advocates in its revenue sharing policy. Our policy calls for a permanently authorized program funded from a fixed percentage of the Federal income tax base. Your proposal would achieve this by permanently authorizing revenue sharing on an entitlement basis and funding it through annual appropriation to a State and local fiscal assistance trust fund of 4 percent of Federal income tax receipts.

As Federal income tax receipts grow over time, the general revenue sharing allocations to State and local governments would increase, preventing the value of revenue sharing dollars from being eroded by inflation and allowing State and local government to participate in a systematic way in the growth of Federal revenues. We feel that this approach is consistent with the original intent of Congress in establishing general revenue sharing. Furthermore, it would provide local governments with a sense of security in their budgetary processes.

The second element of your proposal that is in agreement with NACo policy is the participation of the States in general revenue sharing. You are well aware of the additional responsibilities that State governments have had to assume under block grants established through New Federalism and of the serious fiscal problems confronting many States. A recent survey by the National Conference of State Legislatures reveals that, as a result of the recession, cutbacks in Federal aid, and other factors, 19 States project deficits in their general funds. NACo believes that States need general revenue sharing in order to fulfill their service responsibilities and deal with these fiscal dilemmas without overburdening local governments. Your proposal would bring them back into the program at an initial level of $5.9 billion, an amount that would increase over time as Federal income tax receipts increased.

As you can see, there are several elements of S. 700 that correspond closely to changes in the general revenue sharing program that are advocated by NACo. However, there are also major points of disagreement between our policy and your proposal.

The first of these relates to the allocation formula changes contained in S. 700. The National Association of Counties opposes any alteration of the current revenue sharing formula. The changes your bill proposes generally provide for a distribution of revenue sharing funds to States on the basis of their relative fiscal capacities, as measured by their potential performance under a representative tax system similar to that developed by ACIR, and for a distribution of revenue sharing funds to local governments on the basis of population, tax effort, and relative income. Under the proposal, no local government would receive fewer revenue sharing dollars than it now receives under the current formula. In addition, sub-State allocations would be "detiered," so that county areas would no longer be involved in the distribution process. All local governments within a State would compete with all other local governments for revenue sharing dollars, rather than competing only with those governments located in their county area.

County government allocations over and above the hold harmless level would be affected by these formula changes in two ways: First, at the State level, through changes in the total State "pot" available to the State itself and local governments within the State (including counties) and second, at the local level, where a county would compete with other local governments for funds on the basis of population, tax effort, and relative income, rather than on the current basis of the adjusted taxes it collects compared with those taxes collected by all units of local government within the county area.

At the time of the preparation of this testimony, computer printouts of revenue sharing allocations under the formula changes and increased funding levels proposed by S. 700 were not available from the Treasury Department. The National Association of Counties is eager to learn what these allocations would be and how they would compare with allocations under the current formula at the increased funding level provided for by S. 700. We feel that this comparison is important because two separate issues are involved from the perspective of NACo policy: First, the need for increased funding of general revenue sharing in order to offset the effects of inflation, and, second, the formula changes that are being proposed. We would like to compare local government distributions under the two formulas holding the overall funding level constant at $5.9 billion. It would then be possible to more fully evaluate the impact of the proposed formula changes on individual county governments, as well as on the total allocation for all county governments. Until we have had an opportunity to examine such computer printouts, we are limited in our ability to comment on the practical effects on counties of the changes in the formula elements proposed by S. 700.

The changes in the general revenue sharing formula constraints that are proposed in S. 700 may also affect some county governments in the out-years of the program. Under the current law, county governments are not subject to the maximum and minimum per capita allocation restrictions: S. 700 would subject them to the 175 percent ceiling and 15 percent floor for allocation amounts above those held harmless. Again, NACo has not had the opportunity to evaluate the comparative impact these constraints would have on counties' allocations as the size of the program grew over time. We will not be unable to do so until the computer printouts become available.

That concludes our comments on the formula changes that you have proposed in S. 700, Mr. Chairman. I'd like to move on now to another aspect of your proposal which troubles us. and that is your plan to finance the State and local fiscal assistance trust fund with Federal individual income tax receipts obtained through limiting the deductibility of State and local taxes. The National Association of Counties opposes any attempt to limit the deductibility of these taxes because we feel that it would impair the ability of State and local governments to increase their own-source revenues to provide vital services. The ability of these governments to raise revenues has already been substantially diminished in recent years by a variety of factors. Thirty-nine States have imposed tax limitations on their local governments. In addition, the capital-raising capacity of State and local governments has been weakened through Federal Tax Code changes and a proliferation of tax sheltering instruments which have made tax-exempt bonds less attractive to investors. I might mention also that the just-passed social security reform legislation provides for the inclusion of interest from tax-exempt securities in the income base used to determine the taxable status of the benefits of social security recipients. NACo believes that this will further decrease the desirability of tax-exempt bonds to the household sector, which along with mutual funds currently absorbs 80 percent of the new supply of tax-exempt debt. We are working to have this provision removed.

I list all of these obstacles to the revenue-raising ability of State and local governments to describe for you the context in which counties must evaluate your proposal to limit deductibility of State and local taxes. We believe that limited deductibility would increase taxpayer resistance to higher taxes at the local level and hamper our capacity to raise revenues. We are aware of the economic studies that you have quoted in defense of this proposal which indicate that if a taxpayer's income is reduced by some amount, this willingness to pay State and local taxes is decreased by a significantly lesser amount, so that limitation of deductibility will not produce a dollar-for-dollar loss in the willingness of taxpayers to tolerate higher taxes at the State and local level. We would caution that economic studies do not always accurately reflect the political realities of taxing and spending. I do not believe, for example, that the momentum of the "tax revolt" that swept across the country in the late 70's can adequately be explained by such studies. There is a psychological element of attitudes toward taxation that they do not always capture. As an elected policy maker, I must say that my political experience and instincts lead me to suspect that in my jurisdiction and perhaps in many others, limitation of deductibility would have a more serious effect on the ability of local governments to raise revenues than might be indicated by these studies.

I do not mean to imply that NACo is insensitive to the need to balance the Federal budget. We realize that if the funding for the general revenue sharing program is to be increased as substantially as you have proposed, a source of funds for that increase must be found, and we appreciate the sense of fiscal responsibility that you have demonstrated, Mr. Chairman, in identifying a potential source. However, we would urge that you look to sources other than a limitation on deductibility because of the negative impact this might have at the State and local level. The National Association of Counties would be happy to cooperate with you and your staff in this effort.

I would like to say in summary that our overriding concern regarding the structural changes to revenue sharing that have been proposed in S. 700 is not whether they would create "winners" and "losers" among counties or between counties and other local governments, but rather whether the changes they would effect would generate political obstacles to the timely reauthorization of the program. It is scheduled to expire on September 30, and NACo is most anxious for Congress to take immediate action for renewal. We fear that the sweeping changes proposed by S. 700 could divide the congressional supporters of the current program. The time required to overcome such divisions might be too great to permit speedy reauthorization of the program. Therefore, we respectfully submit, Mr. Chairman, that a longer time period than the one now available to us is necessary to responsibly evaluate your proposal and take steps to implement it, if that evaluation indicates that the changes it contains would substantially improve the structure of the general revenue sharing porgram. The National Association of Counties stands ready to work with you in all efforts to increase the effectiveness of general revenue sharing and we appreciate your continuing interest in the status of state and local governments in our intergovernmental system.

ROBERT J. ORTH—SUMMARY RESUME

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Education: 1962, Alexander Ramsey High School, Roseville, MN; 1966, BA, Political Science, University of Minnesota, Minneapolis, MN; 1969, JD, University of Minnesota Law School, Minneapolis, MN.

Professional: Attorney in private practice since 1969. General practice with an emphasis on small corporate, real estate and estate planning.

Public Service: 1970-72, Justice of the Peace, Shoreview, MN; 1972-74, Planning Commission member, Shoreview, MN; 1974-77 and 1978-81, elected to Ramsey County Board of Commissioners representing District 1.

Current: 1982, re-elected to Ramsey County Board of Commissioners; 1979-82, chairman of the Ramsey County Board, first suburban commissioner, re-elected to this position for an unprecedented four consecutive years; 1980-82, president, Metro Inter-County Association, a voluntary, non-profit association of metropolitan county units of government, working together on problems of mutual interest and common concern, first Ramsey County commissioner to be elected president; 1982, chair, National Association of Counties (NaCo) Subcommittee on Income Maintenance of the Human Services Committee.

Memberships: NaCo Steering Committee on Human Services; NaCo Task Force on Refugees, Aliens and Migrants; Association of Minnesota Counties, Board of Directors; Metropolitan 911 Board; Hazelden Outpatient Advisory Board; East Metro EMS Radio Communications Board; Public Defender Board; Local Government Advisory Task Force on Waste Management; Task Force on Regional Revenues, Metropolitan Council; Inter-Agency Policy Committee on Solid and Hazardous Waste; State Refugee Advisory Council; State Community Health Services Advisory Committee.

Prepared Statement of George Miller

INTRODUCTION

On behalf of the Board of Directors of NATaT, I'd like to thank you for providing the opportunity to testify on this very important topic. As you know, the National Association serves local government officials from over 13,000 smaller communities across the country.

Reauthorization of the General Revenue Sharing program, in its current form, is NATaT's major legislative priority in 1983 for some important reasons: Town governments need GRS funds to help offset the extreme financial limitations of the real property tax—a financial burden that can be alleviated only partially through other taxes, charges, and inkind contributions. Another major financial constraint facing our members is that their taxing authority is in many cases severely limited by state constitutions or statutes . . . revenue sharing helps bridge these gaps in a big way.

A real plus about the GRS program is that it is flexible enough in design to enable townships to use the funds to meet their most pressing real needs—an important factor in an economic climate where financial resources are depleted. And, the minimum of paperwork and regulations in the GRS program guarantees funds to local governments that otherwise would not have the professional capacity to identify and compete for federal aid.

These, Mr. Chairman, are some of the major reasons why America's towns and townships see GRS funds as such an important resource.

SURVEY SHOWS GRS ESSENTIAL

Recognizing that it is not enough for me just to provide anecdotal information to demonstrate support for renewing the revenue sharing program, I am pleased to be able to report that our national office has received revenue sharing use surveys from over 5,000 member towns, including over 900 from townships from the State of Minnesota. This tremendous response, which we expect will ultimately result in over 7,000 returns, provides a clear understanding of the importance of GRS funds to towns.

Mr. Chairman, I will not report in great detail on the findings of this nationwide survey. If it is acceptable to you, we would like to submit for the record a table that does provide more detail—particularly for towns under 10,000 in population.

On the average, GRS constituted 15 percent of the total budget of the localities that responded to NATaT's survey. Over sixty percent stated that revenue sharing is the only Federal money they receive directly. Sixty-five percent of the respondents to the NATaT survey indicated that they would have to raise taxes if their GRS funds are eliminated. Nearly, half said that they would have to cut back programs.

Survey respondents were asked to indicate, from a selection of eighteen public service categories, the number of ways in which they spent their revenue sharing allocation for the current year. The services most frequently supported by revenue sharing dollars, according to the respondents, are: fire and/or rescue; services for the poor, elderly or youth; the disposal of solid and/or hazardous waste; public transportation; parks and recreation; and general administration.

Mr. Chairman, these are some of the general categories in which general revenue sharing dollars were used . . . but, perhaps it is more important to understand exactly how GRS funds were spent within these categories. Our survey asked town officials to describe in detail what specific purchases were made or services delivered with their GRS funds. The response was overwhelming. Examples of how GRS funds were used include purchasing fire helmets and uniforms, installing culverts, sanding and grading roads, buying equipment for rescue vehicles, paying for drug abuse hotlines staffed by volunteers, paying in part for snow removal equipment, developing youth and adult summer recreation programs, purchasing and delivering groceries for senior citizens, providing courses for senior citizens, paying in part for local parks, purchasing police uniforms and police vehicle radar equipment, and purchasing school books for children from welfare families . . . the list goes on.

We hope this information is helpful to the Senate as it deliberates the future of the revenue sharing program. We believe that the response to the NATaT nationwide survey demonstrates that towns and townships are spending their GRS funds in a responsible manner consistent with Congressional intent. For these reasons, NATaT enthusiastically endorses reauthorization of the program. Towards that end, we are in full support of your bill, Senator Durenberger, S. 41.

CHANGES IN THE PROGRAM

Mr. Chairman, the NATaT Board of Directors recently adopted additional policy concerning GRS, that I'd like to mention briefly. With respect to bringing States back into the program, NATaT supports a State revenue sharing program, as long as funds allocated for local share are not used to finance the State portion of the program. The Association favors reauthorizing the program for at least three years, but preferably a longer period. Concerning the administration's proposed local fiscal assistance block grant of 1983, we do not support the concept of combining the entitlement portion of the Community Development Block Grant with the General Revenue Sharing program. The NATaT Board of Directors believes that this legislative proposal might possibly confuse the original intent of the General Revenue Sharing program, and would be harmful to local governments.

On another matter, we do not see a need to make any changes in the current GRS formula. While the current formula is not perfect, in our view it is fair and equitable—particularly given the enormous diversity which exists among the over 39,000 eligible recipients.

Despite NATaT's strong support of the current formula, the Association does keep an open mind about proposals which are intended to improve the program, such as your bill, Mr. Chairman—S. 700. Before I address the specifics of this initiative, I'd like to provide NATaT's perspective on the current formula.

For the most part, the current formula uses two criteria in determining a local government's allocation: taxes as defined by the U.S. Bureau of Census which includes ad valorem and sales taxes, licenses, and permits; and per capita income. In general, a government's allocation increases when its relative per capita income falls or when its adjusted taxes rise. The relationship of these factors compared with similar factors for other competing governments within a county area determines the actual amount of a local government's allocation.

Mr. Chairman, the current formula assumes that the only way for local governments to finance needed services is by levying certain taxes. The assessment of user fees, in-kind contributions, and special assessments, for example, are excluded entirely in the GRS entitlement computation process. In addition, the formula does not take into account that part of the local government work force which receives no pay at all for services rendered a locality. To summarize, Mr. Chairman, the current formula is deficient in that it does not reflect a locality's use of special fees or user charges, use of volunteer labor, and other alternative mechanisms that may be used by local governments—particularly rural jurisdictions—to provide public services. As a result, the formula for the General Revenue Sharing program tends to overlook the unique character and special nature of smaller units of local government.

Still, Mr. Chairman, it is our opinion that these limitations do not warrant changing the formula. During the past ten years the Congress has discussed the possibility of altering the formula on several occasions, but has concluded that the difficulty of designing a formula for so many local governments would make it impossible to create one that is perfect. The current formula, though, comes pretty close.

NATAT POSITION ON S. 700

With this information by way of background, Mr. Chairman, I would like to address your request for our association's views on the formula changes proposed in S. 700, the State and Local Fiscal Assistance Act of 1983. I'd like to preface my remarks by stating that NATaT policy on the general revenue sharing program, to date, does not encompass all of the major provisions of S. 700. Consequently, my comments are presented with qualifications.

NATaT supports, without reservation, your efforts to create a permanent Revenue Sharing Trust fund and to bring the States back into the program according to a formula based on fiscal capacity. The Association also supports funding the increased costs with increased revenues from a fixed percentage of the Federal individual income tax. For the short term, however, we support this funding mechanism only as long as the current 4.56 billion for the local share is funded from general revenues.

Mr. Chairman, our greatest concern about the aforementioned issues is that a protracted discussion on changes in the program may endanger its chances for renewal. A delay in the reauthorization process could provide critics of the program with an opportunity to defeat its reauthorization. The importance of the program to towns and townships cannot be overstated. So, while strong support exists for the merits of your proposal, our outlook is tempered by the specific knowledge that towns would experience extreme fiscal distress if the program is not renewed.

The NATaT Board of Directors views with reservations the modifications which S. 700 would make to the current three factor intrastate formula. In our opinion, any attempt to modify the formula might well result in unforeseen inequities. In particular, I am referring to the provisions that would "detier" the intrastate formula, adjust the floor and ceiling for entitlements, and replace the existing 50-percent budget constraint with a variable budget constraint. Despite the fact that a hold harmless provision is included that would guarantee each local government would receive at least the same amount of funds it receives under the current formula, the long term impact of the changes to the formula is unclear.

Our initial review of the proposed changes, Mr. Chairman, suggests that, over time, smaller units of local government would tend to receive lesser amounts of general revenue sharing funds proportionate to larger, more urbanized local governments. Since we are without the data at present to confirm the impact on towns in the long term, NATaT is unable to take a position at this time.

CONCLUSION

Mr. Chairman, this concludes my remarks. On behalf of the NATaT Board of Directors, I want to thank you and the entire subcommittee for providing me with the opportunity to share our views on the general revenue sharing program. I'd also like to express the sincere appreciation of our membership for your consistent and strong support of local government. Your efforts to improve our intergovernmental system of government are well recognized and appreciated by towns and townships nationwide. Thank you.

NATIONAL GENERAL REVENUE SHARING SURVEY

Population range: 0 to 9,999.
Number of responses: 2,057.
Percent of total responses: 97 percent.
Average percent revenue sharing is of total budget: 14.9 percent.
Percent indicating revenue sharing is only direct Federal money received: 62 percent.
The figures below represent percent of respondents indicating this option.

Current use of revenue sharing dollars:

Fire and/or rescue: 28.3 percent.
Public transportation: 71.3 percent.
Services for the youth, elderly, poor: 14.8 percent.
Parks/recreation: 7.2 percent.
Solid hazardous waste disposal: 4.5 percent.
General administration: 8.3 percent.

IMPACT OF LOSS OF THE GENERAL REVENUE SHARING PROGRAM

Raise taxes: 65.6 percent.
Cut back programs: 45.6 percent.
Postpone/halt capital improvements: 16.7 percent.
Go into debt: 12.4 percent.
Lay off employees: 2.9 percent.

PREPARED STATEMENT OF CHRIS LINDLEY

Mr. Chairman and members of the subcommittee, my name is Chris Lindley. I am a Councilmember of the City of Rochester, N.Y., a member of NLC's Advisory Council to the Board, and a member of NLC's Task Force on Revenue Sharing.

The National League of Cities, as you know, represents approximately 15,000 cities directly and through their membership in 49 state municipal leagues. Our member cities range in size from New York City to Scotland Neck, North Carolina.

Early reauthorization of general revenue sharing is clearly the number one priority of American cities this year. Your recognition of the importance of this effort makes it a special honor to appear here today. As you know, there has been widespread and active support since last fall to build support for early reenactment of GRS as a separate bill. It is not too difficult to see why.

GRS is the single largest program of federal aid to local governments, providing $4.6 billion annually.

GRS is the most comprehensive of all federal aid programs, providing funds to cities of all sizes in all regions of the country.

GRS is a targeted program, weighted toward those communities that are doing most to help themselves.

And GRS is the most flexible of all federal aid programs, allowing funds to be used for a wide range of programs and activities, as determined at the local level, and giving localities the opportunity to respond quickly to new problems and distress, such as the growing number of homeless in our communities.

Despite hopeful signs in the economy, cities are confronted with severe fiscal problems. As you know, there is little likelihood that we can look to the states for assistance; rather we must anticipate that many states will, in fact, be forced to reduce assistance to local governments. Consequently, we cannot afford the reenactment delays which marked the 1980 reenactment process in the Congress, when we missed the reenactment deadline and very nearly missed a quarterly payment.

Our city surveys indicate that better than 50 percent of our members have fiscal years commencing on July 1. For these cities, the harsh decisions of what further service and personnel reductions are required and what further revenue enhancements must be made are already here. Any delay in reenactment, or any formula change which would reduce a city's allocation, becomes a critical factor in planning how to respond to current municipal fiscal problems. We would hope to avoid any further uncertainties.

To enable us to give you specific data on the role of revenue sharing in our cities, we conducted a survey of nearly 700 of our member cities. That survey, which you have cited in your efforts in our behalf, provides a clean indication of the importance of GRS to all cities, especially small cities. Indeed, for almost a third of all cities, GRS is the only direct federal aid. For cities under 10,000 population, it is the only federal aid for 62 percent.

Mr. Chairman, I would ask permission to insert the findings of our survey into the record following my testimony.

Let me now turn to our recommendations with respect to reauthorization, approved just recently by our Board of Directors.

First, we recommend a five-year extension of the current program, assuring local governments that this essential aid will be available for a reasonable period.

Second, we recommend a reasonable funding increase.

Although GRS is an entitlement program, its funding level has remained unchanged at $4.6 billion for the last seven fiscal years. In that time of increasing fiscal distress, we estimate that GRS has lost at least half its value to inflation.

Recognizing the difficulty of today's budget problems and your necessary emphasis on reducing federal deficits, we nevertheless believe that current municipal fiscal distress and substantial federal aid reductions justify a 20–25 percent increase.

Third, we believe the current formula should be maintained, as well as all existing program requirements (such as financial accountability, citizen participation, and compliance with the civil rights of the nation's citizens). The important role of the tax effort factor assures primary assistance to those communities making efforts to help themselves. While no formula is perfect, the current GRS formula is widely considered to be fair and effective. Absent compelling reasons, we do not support significant changes.

And fourth, we strongly support the retention of the entitlement feature of GRS. This automatic feature is essential to our cities to insure proper planning and budgeting. Any change would only add another layer of confusion and complication to the already difficult process of estimating prospective changes in municipal revenues.

Now, Mr. Chairman, you have specifically requested us to address the questions of the equity of the existing formula and NLC's views on formula changes in your proposed legislation, S. 700.

Our current national municipal policy differs from previous NLC policy. Previously, we supported increasing the maximum constraints and "detiering," as long as there were funding increases to assure that such changes did not, in fact, hurt some cities.

When our Finance, Administration, and Intergovernmental Relations steering committee met last October, it met specifically to consider possible formula changes, including whether to eliminate severance taxes. Speakers from the Congressional Research Service and the administration were invited to discuss tax exportation generally and a Treasury study on how modifying the tax effort factor would affect GRS allocations.

While it is interesting to note that Michigan was the first state to impose a severance tax, and that your state, Mr. Chairman, imposed a severance tax more than a century ago, the two speakers' presentations made clear the exceptional difficulty—if not practical and equitable impossibility—of achieving significant improvements in the GRS formula with regard to tax exports. It became clear that although there might be flaws in the current program, there is insufficient data now available to remedy or eliminate such flaws. Indeed, we might well end up merely changing, rather than removing, the flaws.

At the same time we were struggling with these issues, Mr. Chairman, we were reviewing the returns from our NLC survey of city fiscal conditions. It demonstrated that costs are increasing faster than revenues, and that cities are being forced to increase fees and taxes, lay off employees, and cut needed services. Indeed, last year cities increased taxes approximately 5 percent in the midst of the worst economic times in half a century. I think the committee will find the survey of current fiscal conditions disheartening, and I would ask, Mr. Chairman, that a copy be inserted in the record at the close of my testimony.

As it was discussed by both the committee, and subsequently at our annual meeting, providing a means to help all cities meet their fiscal distress became an overriding concern. Although we have been willing to support reductions in other discretionary and entitlement programs, GRS is of greater benefit to all cities than any other federal program. Thus, we believe the greatest priority should be to give all cities a reasonable increase to confront the severity of the current problems. We believe that if new funds are approved for the programs, our most important purpose must be to help all at a time of extraordinary need.

We know, as you know, Mr. Chairman, that every formula change creates enemies and antagonisms. We have not been afraid to consider changes which, in our view, can create substantive improvements. In the case of GRS, we believe that the formula has achieved wide support and has served its purposes—in large part by relying upon tax effort.

Our interest, concern, and responsibility, which we believe and think you share, is to ensure that cities have the ability to recover and to assist their citizens as quickly as possible.

Thank you.

Senator DURENBERGER. The hearing is adjourned.

[Whereupon, at 12:30 p.m., the subcommittee was recessed to reconvene at the call of the Chair.]

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

WORKING PAPERS ON THE NEW FEDERALISM

FISCAL CAPACITY AS A METHOD OF ALLOCATING FEDERAL GRANT FUNDS

INTERGOVERNMENTAL REPORT

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ON
INTERGOVERNMENTAL RELATIONS

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February 1983

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FOREWORD

This working paper analyzes the concept of fiscal capacity--in particular, the representative tax system (RTS). The report shows how the RTS works, relates its potential impact on Texas and other states, and compares the RTS with per capita income. The report also introduces the concept of needs measurement and assessment, or the expenditure side of federal grant allocation formulas.

With this second working paper, the Commission continues its monitoring activities of the federal government grant-in-aid process. The first working paper, issued in April 1982, described President Ronald Reagan's "New Federalism" proposal, intergovernmental fiscal trends, and the effects of FY 1982-83 budget cuts and block grants.

The Commission thanks the following individuals for reviewing drafts of this report: Jim Ray, Ray Associates, Inc.; Frank Sturzl, Texas Municipal League; Dave Kreider, Texas Governor's Office; and Norman Butts, County Commissioner Bob Honts' office.

R. Bruce Hatfield provided statistical support for this report. Jorge Anchondo and Jay Stanford prepared this report with editorial assistance from Anne Souby.

January 1983
Austin, Texas

Bob Honts
Chairman

CONTENTS

FISCAL CAPACITY AS MEASURED BY THE REPRESENTATIVE TAX SYSTEM 2

Tax Capacity 2
Tax Effort 4
Impact of Fiscal Capacity on Formula Allocations 4

HOW THE REPRESENTATIVE TAX SYSTEM WORKS 5

Tax Capacity Index of Texas and Other States 5
Tax Effort Index of Texas and Other States 7

IMPACT OF THE REPRESENTATIVE TAX SYSTEM ON SELECTED FEDERAL PROGRAMS 9

Medicaid 9
General Revenue Sharing 10

COMPARISON OF PER CAPITA INCOME AND THE RTS AS A MEASURE OF FISCAL CAPACITY 11

Federal Programs Affected 11
Limitations of Per Capita Income Data 12
Advantages of Per Capita Income Data 12

NEEDS MEASUREMENT AND ASSESSMENT 13

CONCLUSION 14

APPENDIXES

1. FISCAL CAPACITY COMPARISONS BETWEEN PER CAPITA INCOME AND THE REPRESENTATIVE TAX SYSTEM, 1979 17
2. FUNDING CRITERIA FOR TOP FOUR FEDERAL PROGRAMS THAT INCLUDE PER CAPITA PERSONAL INCOME AS PART OF THE DISTRIBUTION MECHANISM, 1982 19

REFERENCES 21

CHARTS

1. IMPACT OF TAX CAPACITY ON MEDICAID ALLOCATIONS 3

2. IMPACT OF TAX CAPACITY ON GENERAL REVENUE SHARING ALLOCATIONS 3

FIGURE

1. COMPARISON OF THE PER CAPITA INCOME AND THE REPRESENTATIVE TAX SYSTEM INDEXES FOR TEXAS AND US AVERAGE, SELECTED YEARS 7

TABLES

1. FISCAL CAPACITY COMPARISONS BETWEEN PER CAPITA INCOME AND THE REPRESENTATIVE TAX SYSTEM BY GEOGRAPHICAL REGION, 1979 5

2. TAX CAPACITY INDEXES AND PER CAPITA AMOUNTS OF TEXAS AND SELECTED STATES, 1980 6

3. TAX EFFORT INDEXES BASED ON THE REPRESENTATIVE TAX SYSTEM FOR TEXAS AND SELECTED STATES, SELECTED YEARS 8

4. FEDERAL MATCHING SHARES AND ALLOCATIONS FOR MEDICAID BASED ON CURRENT LAW AND TAX CAPACITY FOR TEXAS AND SELECTED STATES, FY 1982 9

5. COMPARISON OF TAX CAPACITY AND ACTUAL GENERAL REVENUE SHARING ENTITLEMENTS FOR TEXAS AND SELECTED STATES, PERIOD 14--INITIAL ENTITLEMENT, JUNE 1982 10

6. TOP FIVE FEDERAL PROGRAMS THAT INCLUDE PER CAPITA INCOME AS PART OF THE DISTRIBUTION MECHANISM, 1979 12

WORKING PAPERS ON THE NEW FEDERALISM:
FISCAL CAPACITY AS A METHOD OF ALLOCATING FEDERAL GRANT FUNDS

The New Federalism proposal outlined by President Reagan in his 1982 State of the Union address stimulated discussion and debate on many issues of long-range importance for the federal grant system. Most of these issues involve the roles of the respective levels of government for providing services and their responsibilities for providing revenues to fund these services. Other questions raised by the New Federalism proposal, however, concern the methods of allocating grant funds, under a New Federalism trust fund or under currently existing categorical or block grant programs. This report analyzes the use of fiscal capacity measures--in particular, the representative tax system (RTS)--to allocate federal funds.

Under the original New Federalism proposal, the federal government would assume full financial responsibility for Medicaid, and the states would take over Food Stamps and Aid to Families with Dependent Children. The proposal called for the federal government to "turn back" about 40 federal grant programs to the states and establish a temporary trust fund to finance these programs for several years. Subsequent discussion among Administration officials and state and local government leaders resulted in modifications of the original New Federalism proposal. The Reagan Administration may release another version of the plan in early 1983.

As originally proposed by the Administration, the trust fund would allocate money to the states according to the historical distribution pattern of the federal grants affected. Alternative proposals quickly surfaced, however, that would provide for substantially different methods of allocating funds to the states. The fiscal capacity approach, especially the RTS, ranked foremost among these methods. National and regional organizations initially advancing the fiscal capacity approach included the State-Local Coalition (comprised of representatives of the major public interest groups such as the National Governors' Association, National League of Cities, and National Association of Counties) and the Northeast-Midwest Coalition (comprised of members of Congress from 18 states ranging from Maine to Maryland to Minnesota).

As illustrated in this report, the RTS fiscal capacity approach would produce substantial changes in grant allocations among the states and would generally favor northern and eastern states at the expense of western and southern states. Debate on this issue has therefore divided several national associations of public officials and has delayed agreement on the broad outlines of any New Federalism proposal.

Charts 1 and 2 (page 3) illustrate specific examples of the distributional effects of the proposed RTS fiscal capacity approach on Medicaid and general revenue sharing allocations. This approach would substitute tax capacity per capita for personal income per capita in existing federal aid formulas. The charts include the resulting changes in funding for the following states: Florida (FL), Louisiana (LA), Massachusetts (MA), Michigan (MI), New Jersey (NJ), New York (NY), Oklahoma (OK), Pennsylvania (PA), and Texas (TX). The remainder of this report provides background information on the RTS fiscal capacity approach and examines the allocation changes in detail.

FISCAL CAPACITY AS MEASURED BY THE REPRESENTATIVE TAX SYSTEM

Fiscal capacity has various definitions. In general, fiscal capacity denotes an "ability to pay." Currently, many federal grants use personal or per capita income as a measure of "ability to pay" in determining fund allocations to state and local governments.

Recently, however, the US Advisory Commission on Intergovernmental Relations (US ACIR) has advanced a different measurement of fiscal capacity--the ability of a state to finance its services measured in relation to the *average* taxes levied by the states. The US ACIR calls this system of measurement the representative tax system (RTS).[1]

Aggregate state and local government tax indexes determine the RTS. These indexes include tax capacity and tax effort. When applied to grant formulas, the RTS could affect the distribution of funds to states, localities, or both, depending on the purpose and nature of the grant program.

Tax Capacity

Under the US ACIR's RTS concept, the *tax capacity* measurement compares per capita taxes of any given state with a hypothetical amount that could be raised by applying national average tax rates. If tax capacity were substituted for the existing per capita income factor in federal grant formulas, the concept of equalization would shift from the needs of individuals (personal income) toward the hypothetical ability of governments to raise revenue based on national average tax rates. (An explanation of how the RTS works, including the computations of the tax capacity and tax effort indexes, begins on page 5).

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[1] US Advisory Commission on Intergovernmental Relations, *Tax Capacity of the Fifty States: Methodology and Estimates* (Washington, DC: US ACIR, March 1982).

Chart 1

IMPACT OF TAX CAPACITY ON MEDICAID ALLOCATIONS
(Selected States)
(Millions of Dollars)

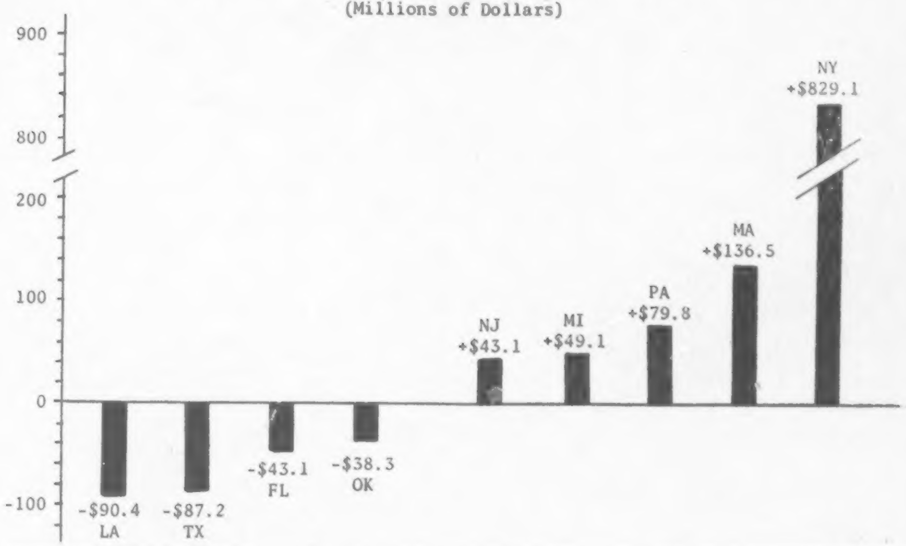
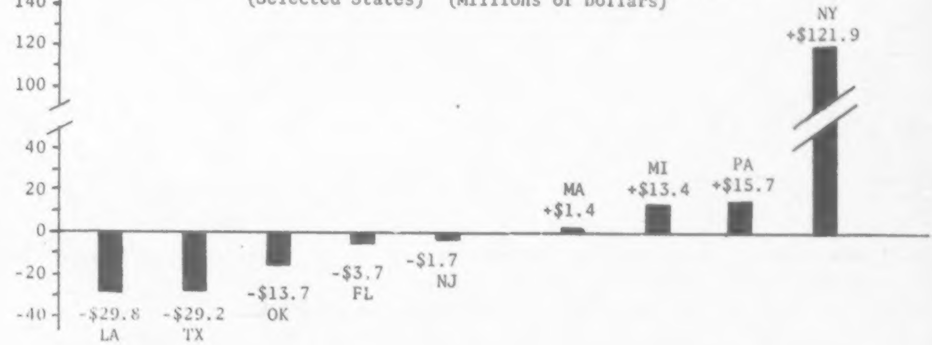


Chart 2

IMPACT OF TAX CAPACITY ON GENERAL REVENUE SHARING ALLOCATIONS
(Selected States) (Millions of Dollars)



SOURCES: (Chart 1) US Advisory Commission on Intergovernmental Relations, *Tax Capacity of the Fifty States: Methodology and Estimates* (Washington, DC: US ACIR, March 1982). (Chart 2) Texas ACIR staff computations based on data obtained from the US Department of the Treasury, Office of General Revenue Sharing, Data and Demography Division, and "Rich States-Poor States: Inequalities in Our Federal System." *Intergovernmental Perspective* 8 (Spring 1982):23.

NOTE: Dollar amounts in millions reflect the change in state allocations resulting from the proposed shift from per capita income to tax capacity per capita.

Tax Effort

Tax effort acts as the counterpart of tax capacity under the RTS. Tax effort basically measures a state's total tax collections compared to a national average. A state with a high tax effort has tax rates that rank significantly above the national average. The US ACIR suggests substitution of the tax effort measurement produced under the RTS for existing tax effort measurements in the general revenue sharing formula.

Impact of Fiscal Capacity on Formula Allocations

As noted in charts 1 and 2 (page 3), sample calculations utilizing an existing federal aid formula may best illustrate the distributional effects of the RTS fiscal capacity approach. A comparison of various fiscal capacity measurements also provides a general gauge of the distributional effects of the RTS approach. Table 1 illustrates the regional patterns among the states by comparing the indexes of tax capacity, tax effort, and per capita income. Appendix 1 lists these indexes for each state.

Generally, the New England and Mideastern states have a high tax effort and a higher-than-average per capita income. These states also have a lower-than-average tax capacity, meaning that these states would benefit from the proposed formula changes (tax capacity in place of per capita income).

In contrast, Southwestern states tend to have a low tax effort and average per capita income. Their collective tax capacity is high, however, meaning that these states would tend to lose substantial funds under the RTS approach.

Of special concern to Texas and a number of other states is that the RTS approach would tend to shift federal grant funds away from states that have relatively low taxes and would reward states that have high taxes compared with the national average. Low tax capacity under the RTS may not necessarily denote a poor state. New York, ? for example, has low tax capacity but high per capita income. High levels of discretionary spending may produce low tax capacity. High spending by some states absorbs potential federal tax revenue from other states such as Texas that manage funds conservatively or have a smaller appetite for public goods and services.

The RTS focuses strictly on revenue production and does not consider expenditure needs. The RTS would reward states that have a low tax capacity without considering their actual needs or level of discretionary expenditures. Therefore, using expenditure needs to counterbalance revenue capacity merits further study as an alternative in developing other allocation criteria.

Table 1

FISCAL CAPACITY COMPARISONS BETWEEN PER CAPITA INCOME AND THE REPRESENTATIVE TAX SYSTEM BY GEOGRAPHICAL REGION, 1979

Region	Tax Capacity Index	Tax Effort Index	Per Capita Income Index
US Average	100	100	100
New England	93	122	102
Mideast	93	134	104
Great Lakes	103	99	104
Plains	101	95	98
Southeast	89	86	87
Southwest	116	71	98
Rocky Mountain	108	93	95
Far West	115	96	113

SOURCE: US Advisory Commission on Intergovernmental Relations, *Tax Capacity of the Fifty States: Methodology and Estimates* (Washington, DC: US ACIR, March 1982), pp. 20, 21, 44, 45.

HOW THE REPRESENTATIVE TAX SYSTEM WORKS

The tax capacity index measures a state's fiscal capacity compared with the national average tax rate capacity of 100 percent. Eight tax bases comprise the sources for developing each state's indexes. These eight tax bases include general sales or gross receipts, selective sales taxes, license taxes, individual income, corporate income, property taxes, estate and gift taxes, and severance taxes. The US ACIR used a proxy for states that did not have a particular tax. For example, some states, including Texas, do not have a personal income tax. The US ACIR used the federal income tax liability as the measure of personal income and applied an average effective tax rate to it. The following examples illustrate the calculation of index numbers for tax capacity and tax effort under the RTS.

Tax Capacity Index of Texas and Other States

Texas has one of the highest tax capacity indexes of the 50 states. As illustrated by the following example, a preliminary 1980 tax capacity index of the states produced by the US ACIR assigns Texas an index of 124 percent, or a 24 percent greater ability to raise revenue than the national average. This index is slightly more than the 1979 figure for the state, 122 percent. Only three other states--Alaska, 260 percent; Nevada, 154 percent; and Wyoming, 196 percent--have higher indexes than Texas' index. (Appendix 1 shows how Texas compared with other states in 1979.)

Tax Capacity Index

$$\frac{\text{Texas' Tax Capacity}}{\text{US Tax Capacity (Average)}} = \frac{\$1{,}173 \text{ (Per Capita)}}{\$949 \text{ (Per Capita)}} = 124 \text{ Percent}$$

Of the states with a 1980 population of over 10 million, Texas has the highest tax capacity figure (see table 2). California (117) and Illinois (108) are the only large states to exceed the national average. On the other hand, New York (90) and Pennsylvania (93) rank below the national average for tax capacity. New York also has the highest tax effort of any state, indicating a high degree of utilization of available tax sources.

Table 2

TAX CAPACITY INDEXES AND PER CAPITA AMOUNTS OF TEXAS AND SELECTED STATES, 1980

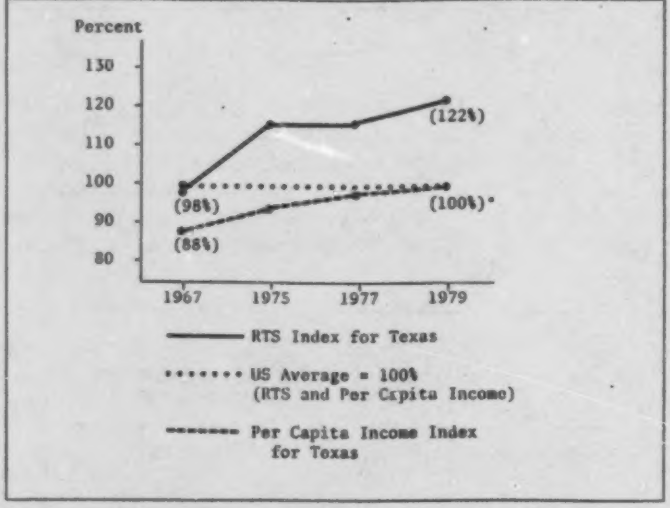
State	Population	1980 Tax Capacity Index (Preliminary)	Tax Capacity Per Capita
New York	17,602,000	90	$ 855
Pennsylvania	11,871,000	93	879
Illinois	11,462,000	108	1,021
Ohio	10,781,000	97	918
Florida	10,183,000	100	949
California	24,196,000	117	1,110
TEXAS	14,766,000	124	1,173
National	229,311,000	100	949

SOURCE: "Rich States-Poor States: Inequalities in Our Federal System," *Intergovernmental Perspective 8* (Spring 1982):23. State population figures from the US Department of the Treasury, Office of General Revenue Sharing, Data and Demography Division, December 14, 1982.

Figure 1 provides a historical picture of the per capita income and RTS fiscal capacity measurements for Texas. Both indexes ranked below the US average in 1967. In subsequent years both indexes grew, although the RTS index grew at a considerably higher rate. By 1979, Texas had an RTS index of 122 percent, or a capacity 22 percent greater than the national average. (The amount increased to 124 percent in 1980.) As the figure shows, the state had a 1979 per capita income index of 100 percent, the same as the national average.

Figure 1

COMPARISON OF THE PER CAPITA INCOME AND THE REPRESENTATIVE TAX SYSTEM INDEXES FOR TEXAS AND US AVERAGE, SELECTED YEARS



SOURCE: Texas ACIR staff computations based on data obtained from *Tax Capacity of the Fifty States: Methodology and Estimates* (Washington, DC: US ACIR, March 1982), pp. 133-34.

Tax Effort Index of Texas and Other States

The US ACIR has computed for four selected years--1967, 1975, 1977, and 1979--a tax effort index based on the representative tax system. Texas had the lowest tax effort for these four years of the 50 states and the District of Columbia. An example of this calculation appears on page 8.

Tax Effort Index

$$\frac{\text{Texas' Total Tax Collections}}{\text{Hypothetical Amount That Could Be Collected in Texas Based on National Average Tax Rates}} = \frac{\$\ 9.05\text{ Billion}}{\$14.40\text{ Billion}} = 63\text{ Percent}$$

The ACIR's calculations show that Texas' tax effort index declined from 75 percent in 1967 to 63 percent in 1979. This index means that in 1979, for example, Texas' tax effort reached only 63 percent of the US average of 100 percent, or that Texas had 37 percent less tax effort than the national average. Table 3 compares Texas' RTS tax effort with that of the same states listed in table 2.

As seen in table 3, unlike Texas, New York's RTS tax effort index has risen the most of the 50 states and the District of Columbia, growing from 138 percent in 1967 to 172 percent in 1979, or an increase of 34 percentage points. New York's tax effort index means that in 1979, the state taxed itself 72 percent higher than the US average of 100 percent.

Table 3

TAX EFFORT INDEXES BASED ON THE REPRESENTATIVE TAX SYSTEM FOR TEXAS AND SELECTED STATES, SELECTED YEARS

State	Tax Effort Index			
	1979	1977	1975	1967
New York	172	169	160	138
Pennsylvania	105	94	93	99
Illinois	99	96	99	84
Ohio	86	78	80	82
Florida	79	73	74	84
California	95	117	119	108
TEXAS	63	67	66	75

SOURCE: Texas ACIR staff computations based on data obtained from *Tax Capacity of the Fifty States: Methodology and Estimates* (Washington, DC: US ACIR, March 1982), pp. 44-45.

IMPACT OF THE REPRESENTATIVE TAX SYSTEM ON SELECTED FEDERAL PROGRAMS

The use of a tax capacity index in federal programs that now have a per capita income index factor would cause Texas to experience substantial reductions in its grant allocations. Table 4 lists Texas and other selected states and shows how the RTS tax capacity would affect Medicaid, the largest funded federal program that presently uses a per capita income factor in the allocation formula. Similarly, table 5 shows how Texas and the same selected states would fare if tax capacity per capita replaced personal income in the general revenue sharing (GRS) formula.

Medicaid

Of states with comparable populations listed in Table 4, Florida would have the largest share decline in Medicaid, followed closely by Texas. The Texas federal Medicaid allocation, however, would drop the most of these seven states ($87.2 million) while Florida would lose less than half of the Texas share ($43.1 million). (Of the 50 states and the District of Columbia, only Louisiana, with a loss of $90.4 million, would lose more money than Texas.) New York would gain the most both in shares (15.13 percent) and allocations ($829.1 million).

Table 4

FEDERAL MATCHING SHARES AND ALLOCATIONS FOR MEDICAID
BASED ON CURRENT LAW AND TAX CAPACITY FOR TEXAS AND SELECTED STATES, FY 1982
(In Millions of Dollars)

State	Federal Matching Shares*				Federal Medicaid Allocations		
	Current Law	Tax Capacity	Difference		Current Law	Tax Capacity	Difference
New York	50.88%	66.01%	+15.13%		$2,787.7	$3,616.8	+$829.1
Pennsylvania	56.78%	61.52%	+ 4.74%		$ 956.5	$1,036.3	+$ 79.8
Illinois	50.00%	50.00%	-0-		$ 722.0	$ 722.4	-0-
Ohio	55.10%	55.70%	+ .60%		$ 726.5	$ 734.4	+$ 7.9
Florida	57.92%	51.38%	- 6.54%		$ 381.0	$ 338.0	-$ 43.1
California	50.00%	50.00%	-0-		$2,350.7	$2,350.7	-0-
TEXAS	55.75%	50.00%	- 5.75%		$ 845.5	$ 758.3	-$ 87.2

SOURCE: Texas ACIR staff computations based on data obtained from *Tax Capacity of the Fifty States: Methodology and Estimates* (Washington, DC: US ACIR, March 1982), pp. 36-37.

*According to US ACIR, *Tax Capacity of the Fifty States*, p. 35, "Each state's grant allocation is basically determined by the product of the amount the state chooses to spend on Medicaid benefits and its federal matching share. . . . The federal matching share has a minimum of .5 and a ceiling of .83 . . . . Because state per capita income is the only variable in the formula that changes from state to state, the federal matching share will only vary between two states if they have differing per capita incomes--the higher income states having lower matching shares, and vice versa."

Twenty-one of the fifty states and the District of Columbia would gain in federal matching shares by using the RTS tax capacity index. The gains for these 21 states range from .19 percent for Nebraska to 15.13 percent for New York. Conversely, 22 states would lose portions of their federal matching shares. The losses range from .09 percent for Mississippi to 17.19 percent for New Mexico. Seven states and the District of Columbia would retain their same shares and allocations.

General Revenue Sharing

Texas would have the largest total entitlement loss, $29.2 million, of the seven states listed in table 5. Five of these seven states, including Texas, would receive less money from the tax capacity entitlement than from the 1982 GRS funding formula.

Table 5

COMPARISON OF TAX CAPACITY AND ACTUAL GENERAL REVENUE SHARING ENTITLEMENTS FOR TEXAS AND SELECTED STATES, PERIOD 14--INITIAL ENTITLEMENT, JUNE 1982

State	Tax Capacity Entitlement*	Actual General Revenue Sharing Entitlement	Difference	Percent Change
New York	$587,176,305.90	$465,304,827.00	$+121,871,478.90	26.2%
Pennsylvania	237,993,395.60	222,311,797.00	+ 15,681,598.50	7.0%
Illinois	209,337,436.20	213,047,060.00	- 3,709,623.80	- 1.7%
Ohio	170,441,553.40	173,162,272.00	- 2,720,718.60	- 1.6%
Florida	160,355,153.40	164,030,662.00	- 3,675,508.60	- 2.2%
California	498,017,968.30	511,835,684.00	- 13,817,715.70	- 2.7%
TEXAS	218,094,020.40	247,345,247.00	- 29,251,226.60	-11.8%

SOURCE: Texas ACIR staff computations based on data obtained from the US Department of the Treasury, Office of General Revenue Sharing, Data and Demography Division, and "Rich States-Poor States: Inequalities in Our Federal System," *Intergovernmental Perspective 8* (Spring 1982):23.

*Tax capacity per capita based on 1980 data.

The total entitlement losses of four of the states in table 5 would amount to less than the amount lost by Texas. As with Medicaid, of the 50 states and the District of Columbia, only Louisiana, with a loss of $29.8 million, would lose more money than Texas. Likewise, New York would gain the most allocations, $121.9 million, and would have the largest percent increase, 26.2 percent.

Thirty-six of the fifty states and the District of Columbia would lose in their total entitlements by using tax capacity per capita. The losses for these 36 states range from .4 percent for Virginia to 36.1 percent for Wyoming. Conversely, 15 states would gain in entitlements. The gains range from .1 percent for Maryland to 26.2 percent for New York.

COMPARISON OF PER CAPITA INCOME AND THE RTS AS A MEASURE OF FISCAL CAPACITY

Federal Programs Affected

In 1979, per capita income appeared in the funding formulas of 29 federal programs. Of these 29 programs, five accounted for about 36 percent of the $82.9 billion total grants-in-aid awarded to state and local governments in 1979.[2]

Table 6 (page 12) shows that Medicaid ranked as the most important program with obligations of $12.8 billion. General revenue sharing received $6.9 billion followed by Aid to Families with Dependent Children (AFDC) with $6.6 billion. The median obligation for the 29 programs in 1979 amounted to $47 million.

Appendix 2 shows the other funding criteria besides per capita income of four of the five programs listed in table 6. The tax effort index calculated under the RTS could potentially affect the present tax effort factor of the general revenue sharing formula.

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[2] Federal aid to state and local governments is defined as the provision of resources by the federal government to support a state or local program of governmental service to the public. The three primary forms of aid are grants-in-aid (including shared revenues), loans, and tax expenditures.

Table 6

TOP FIVE FEDERAL PROGRAMS THAT INCLUDE PER CAPITA INCOME AS PART OF THE DISTRIBUTION MECHANISM, 1979

Program	1979 Obligations (In Billions of Dollars)
Medical Assistance Program (Medicaid)	$12.8
State and Local Government Fiscal Assistance (General Revenue Sharing)	$ 6.9
Assistance Payments--Maintenance Assistance (State Aid)(AFDC)	$ 6.6
National School Lunch Program	$ 2.0
Rehabilitation Services and Facilities--Basic Support (Basic Support Program)	$ .8

SOURCE: US Advisory Commission on Intergovernmental Relations, *Tax Capacity of the Fifty States: Methodology and Estimates* (Washington, DC: US ACIR, March 1982), pp. 133-34.

Limitations of Per Capita Income Data

The US ACIR has observed that "none of the income measures estimated by government agencies is based on a comprehensive definition of income." The ACIR further notes that the "primary difficulty in measuring state income is a lack of accurate and timely data for such items as imputed income, unrealized property income, and workplace/residency adjustments."[3]

Advantages of Per Capita Income Data

Advocates of per capita income cite almost the opposite reasons that the US ACIR gives for continuing its use. They state that policymakers can understand its concept better--which allows for greater consensus and compromise. Comparisons between states become less complicated and fewer questions persist regarding the data's authenticity.

The advocates state that, while the data have imperfections, the federal agencies that collect the data have considerable experience doing this work. They also note that these federal agencies collect and make available some types of income data on an annual basis.

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[3] US ACIR, *Tax Capacity*, p. 6.

NEEDS MEASUREMENT AND ASSESSMENT

The New Federalism may also provide a chance for federal lawmakers to reexamine the expenditure side of federal grant allocation formulas. The federal grant allocation process does not currently include a systematic method of determining which geographic areas may have the greatest expenditure needs. The history of federal grant programs shows that the Congress has considered needs on a program-by-program basis.

In November 1982, the US ACIR prepared a staff paper highlighting the problems inherent in devising an equitable system of grant allocation.

> If only capacity is measured as the basis for redistributing federal revenues, 'needs' per capita are assumed to be relatively uniform across all jurisdictions. Conversely, measuring only expenditure needs as the basis for redistributions implies that the per capita capacity of all jurisdictions to raise money for meeting those needs is about the same. The logic is flawed on both sides so there is interest in trying to find valid ways of measuring both needs and capacity.[4]

The staff paper also outlines some of the problems and choices that may result in trying to develop a need-based system for grant allocations. Four possible techniques for measuring needs for public services are suggested:

(1) Specific need indicators or socioeconomic characteristics such as population, health, and employment trends, and housing and highway conditions.

(2) Proxy need indicators such as available spending or tax effort levels related to social needs.

(3) Needs assessments such as the number of persons needing a program (for example, handicapped children) and the financial costs of providing a standard level of service to each clientele group needing a service.

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[4] US Advisory Commission on Intergovernmental Relations, "Needs Measurement and Equalization" (Washington, DC: US ACIR Staff Paper, November 1982), p. 6.

(4) Weighted-average population and composite cost measures that identify need groups and establish cost-of-living or cost-of-government indexes.[5]

These four techniques may provide a good basis for developing better-defined need criteria. A more careful and thorough study of needs may also help to answer expenditure-related questions posed by designated "high capacity" and "low effort" states like Texas. For example, do high tax effort states also have high discretionary expenditures? Do high tax levels reflect necessary needs? Do historical expenditure levels adequately depict current needs?

CONCLUSION

Under most interpretations, the underlying purpose of federal aid programs is to reduce or eliminate social, structural, or environmental problems. Difficulties in measuring those needs accurately through any type of formula approach are well known. Also, states differ significantly in their ability to finance independently improvements in these problem areas.

The RTS measures tax capacity or wealth by estimating the amount of revenue each state and its political subdivisions could raise if they used a hypothetical set of average tax rates. If tax capacity were to replace per capita income in federal aid formulas, grant allocations among the states would change substantially. Generally, the RTS approach favors the northern and eastern states at the expense of the western and southern states.

Measuring state revenue-raising capability through the RTS deals with only half of the equation. The RTS concept would redistribute federal funds without consideration of program needs or the severity of prevailing problems. The RTS may, in fact, result in the transfer of wealth to states that have high discretionary expenditures.

Future modifications to the RTS might be considered so as to prevent transfers of wealth from states that have chosen modest expenditure levels to states that have constructed large and costly public sectors. Studies toward that end could develop some type of needs measurement index to counterbalance the tax capacity index. An expenditure index based on average expenditure levels among the states could provide a more balanced approach to federal grant program allocations. In any case, failure to consider both revenue capacity and expenditure needs may jeopardize the tenuous compromise that sometimes occurs in the funding of federal grant programs for states and localities.

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[5] Ibid, pp. 8-9.

Appendix 1

FISCAL CAPACITY COMPARISONS BETWEEN PER CAPITA INCOME AND THE REPRESENTATIVE TAX SYSTEM, 1979

State	Tax Capacity Index	Tax Effort Index	Per Capita Income Index
US Average	100	100	100
New England	93	122	102
Connecticut	106	102	115
Maine	80	111	80
Massachusetts	91	145	101
New Hampshire	97	78	95
Rhode Island	84	123	97
Vermont	86	110	84
Mideast	93	134	104
Delaware	111	95	106
District of Columbia	107	133	120
Maryland	98	110	106
New Jersey	101	117	111
New York	87	172	104
Pennsylvania	92	105	98
Great Lakes	103	99	104
Illinois	112	99	112
Indiana	97	84	98
Michigan	102	114	107
Ohio	99	86	99
Wisconsin	96	119	97
Plains	101	95	98
Iowa	106	93	100
Kansas	107	86	105
Minnesota	102	116	101
Missouri	95	83	94
Nebraska	96	98	99
North Dakota	106	77	94
South Dakota	92	84	85

(Continued)

Appendix 1 (Continued)

State	Tax Capacity Index	Tax Effort Index	Per Capita Income Index
Southeast	89	86	87
Alabama	76	87	79
Arkansas	78	82	79
Florida	104	79	97
Georgia	83	97	87
Kentucky	86	86	84
Louisiana	108	79	86
Mississippi	71	96	70
North Carolina	82	92	84
South Carolina	77	92	80
Tennessee	81	87	84
Virginia	93	89	98
West Virginia	95	81	84
Southwest	116	71	98
Arizona	95	116	96
New Mexico	105	84	86
Oklahoma	113	71	97
Texas	122	63	100
Rocky Mountain	108	93	95
Colorado	111	96	104
Idaho	91	92	86
Montana	111	88	88
Utah	88	99	82
Wyoming	179	79	113
Far West	115	96	113
California	116	95	115
Nevada	164	65	120
Oregon	105	94	102
Washington	103	97	109
Alaska	215	126	128
Hawaii	105	128	105

SOURCE: US Advisory Commission on Intergovernmental Relations, *Tax Capacity of the Fifty States: Methodology and Estimates* (Washington, DC: US ACIR, March 1982), pp. 20, 21, 44, 45.

Appendix 2

FUNDING CRITERIA FOR TOP FOUR FEDERAL PROGRAMS THAT INCLUDE PER CAPITA PERSONAL INCOME AS PART OF THE DISTRIBUTION MECHANISM, 1982

Program*	Distribution Mechanism
Medical Assistance Program (Medicaid: Title XIX)	Total state medical assistance expenditures, per capita income by state (three-year average). Maintenance of effort requirement.
Assistance Payments--Maintenance Assistance (State Aid)(AFDC)	Assistance Payments - state's ratio of per capita income. Federal Medical Assistance percentage by states. AFDC - state's average monthly payment of $32 per recipient ($100 per child in foster care). Grant funds pay set percentages within federal average maximum. States may use Medicaid with no maximum (provided the state has an approved plan).
State and Local Government Assistance (General Revenue Sharing)	Use formula that produces higher amount, five factor formula (population, urbanized population, per capita income, state income tax collections, and tax effort) or three factor formula (population, tax effort and relative income).
Rehabilitation Services and Facilities - Basic Support (Basic Support Program)	Per capita income three-year average by state, US and state total population, consumer price index, maintenance of effort requirements.

SOURCE: Office of Management and Budget, 1982 *Catalog of Federal Domestic Assistance* (Washington, DC: Government Printing Office), pp. 58-59, 245-46, 542-43, 880-81.

*The National School Lunch Program did not receive federal allocations based on per capita income in 1982, although it did in 1979 as reflected in Table 6.

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National League of Cities

Policy
Working Paper

City Fiscal Conditions in FY 1983: Dark Clouds on the Horizon

By

Francis Viscount

WP-9

December, 1982

This document contains the results of a survey of current fiscal conditions and their projections for FY 1983. The survey was mailed to 140 cities which are direct members of the National League of Cities during the summer of 1982. It is the first fiscal survey NLC has undertaken.

TABLE OF CONTENTS

Title Page No.

Preface i
List of Tables ii
Introduction and Summary of Findings 1
Methodology 3
Trends in General Fund Revenues and Expenditures . . 5
Full-Time Employment 8
Actions by Cities 10
Capital Spending 12
Conclusion 14
Appendix I Number of Cities Responding to NLC Fiscal Survey By Region and State 15
Appendix II Cities Responding to NLC Fiscal Survey . 16

PREFACE

The following report represents the final results of a survey of current fiscal conditions and the outlook of city officials for conditions in the next fiscal year. The survey was conducted by the Office of Policy Analysis and Development of the National League of Cities. While there have been other surveys of city fiscal conditions conducted over the past year, few have focused on anticipated future conditions, and no other survey has attempted to determine exactly how city officials are coping with reductions in federal aid. The survey instrument, analysis and report were prepared by Francis Viscount, Urban Economist on the staff of the National League of Cities.

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Policy Analysis and
Development

LIST OF TABLES

Title | Page No.
Table 1 Distribution of Responses to Questionnaire . 4
Table 2 Growth Trends in General Fund by Region . . 5
Table 3 Growth Trends in General Fund by City Size . 7
Table 4 Change in Full-Time Employment by Region . . 8
Table 5 Cities that Raised Service Fees - FY 1982. . 10
Table 6 Changes in Tax Rates 1982 11
Table 7 Trends in Municipal Bond Market Conditions . 13

Introduction and Summary of Findings

A number of surveys of state and local fiscal conditions have been completed recently. All have concluded that cities are in bad fiscal shape and conditions will worsen before they improve. NLC's survey of 79 cities corroborates these findings and offers some perspectives on what cities anticipate in FY 82-83. As we noted last summer, in our preliminary report, our survey is not definitive, but no city fiscal survey can be. Our findings are similar in trend and magnitude to the findings by other research efforts, so we feel confident of the general accuracy of the findings.

The following are our major findings:

1. Overall city expenditures continued to grow faster than revenues, a trend that began in the late 1970's and which cities expect to continue during FY 1983, although the difference between growth rates of revenues and expenditures should narrow.

2. This trend occurred on average in all regions and for all sizes of cities. The Midwest experienced the least disparity in growth rates and also lowest overall rates for fiscal 81-82. The South shows the highest growth rate in revenues; the Northeast shows highest growth rate in expenditures.

3. In fiscal 1983 cities are expecting both revenue and expenditure growth rates to decline, as well as the difference between the two. Overall, cities expect revenue to keep pace with inflation and expenditures to slightly exceed it. The regions expecting the greatest imbalance in growth rates are the Northeast and the West.

4. However, in fiscal 1983, when city size is considered, differences emerge. Large cities', over 250,000, planned expenditure and revenue growth rates are very nearly balanced and only slightly above the rate of inflation. Medium sized cities, between 50,000 and 250,000 population, plan to have revenue and expenditure growth 3 percent faster than inflation. Small cities, under 50,000 population, on the other hand, expect almost no revenue growth and plan a much lower expenditure growth than large and medium cities.

5. To stave off the effects of the recession cities are taking action to increase revenues. During fiscal 1982, the clear preference was to raise fees instead of raising taxes. Seventy one percent of the cities surveyed increased existing fees and 38 percent introduced new fees, while 32 percent raised property tax rates and only 13 percent raised sales tax rates. Not surprisingly, very few cities lowered existing tax rates or fee levels.

6. Cities also continued to reduce work forces. Although in 1982 close to the same number of cities reported increases as reported decreases in employment (41 percent versus 49 percent), the relative size of the decrease was 60 percent larger than the increase. In fiscal 1983 the trend is toward additional reductions. The percent of cities reporting planned increases is lower than fiscal 1982, but the percent planning reductions is about the same. Thirty-three percent plan increases while 48 percent plan decreases in fiscal 1983.

7. A regional breakout of fiscal 1982 employment reductions show that they were most prevalent in the Midwest with 75 percent of cities reporting reductions, and least prevalent in the Northeast and West, 30 and 34.5 percent respectively. Surprisingly over half of the cities in the South, 56.6 percent, reported reductions. The Sunbelt definitely has partly-cloudy areas.

8. Conditions in the tax exempt bond market continued to discourage infrastructure investment by cities, even though the tax exempt bond market is heading for record volume in calendar 1982. Only 53 percent of all cities surveyed tried to issue bonds and just over a third of them postponed issues. This finding is close to the 39.7 percent postponement rate reported in a Joint Economic Committee (JEC) fiscal survey.

9. Future market conditions continue to be uncertain, and although interest rates have declined, current relative and absolute tax exempt interest rates are still 25 percent higher than in 1980 and much higher than the prevailing interest rates of the 1970's.

10. When asked if local funds would be used to make up for part of all of the reductions in federal grants, other than general revenue sharing, less than 10 percent of the cities said yes. Only 25 percent of cities said they would make up reductions in general revenue sharing.

The near-term outlook for cities is indeed bleak. With the recession likely to continue and the recovery to be weak and slow, local fiscal conditions, already strained, should worsen. Relief from intergovernmental aid, either state or federal, seems unlikely since their respective fiscal conditions also are demonstrably poor. Cities face a near-term future of either more revenue rate increases, because their local economic and tax bases are not growing, or service cuts. It is important, however, that state and federal government not be allowed to shift the burden of their fiscal problems to cities with deeper cuts in intergovernmental aid during fiscal 1983 and 1984.

I. Methodology

A number of independent surveys of state and local government have been undertaken during the past few years in order to supplement the larger and more complete survey conducted by the U.S. Census Bureau. The need for these surveys are two-fold. There is a lag of 18 to 24 months before the Census Bureau survey appears. Second, many policy questions related to the fiscal condition of cities require greater detail than is available from the Census survey.

The most comprehensive survey of city fiscal conditions, other than the Census Bureau, is prepared by the JEC of the Congress. During each of the past three years, the JEC surveyed around 600 cities, and in its most recent one received responses from approximately one half of them. A survey of that magnitude is currently beyond the capacity of the National League of Cities (NLC) to undertake and we do think it is necessary to duplicate what the JEC does. Often, however, NLC has a narrower set of questions that it wants to analyze more quickly than is possible using either the Census or JEC surveys. In the current case we wanted to get a preliminary look at city fiscal plans for fiscal 1983, to find out whether the federal grant cuts were more important to city fiscal conditions than the recession and whether or not cities would be able to or intended to pick up federal grant cuts with their local funds.

The survey was sent to the NLC direct-member cities represented by the National League of Cities Policy Steering Committee membership. Because these committees are representative of both city size and geographic location, they comprise a reasonable universe from which to draw samples. The response rate was 56 percent, 79 replies from 140 surveys mailed.

A potential bias this sample might have is that they are better off fiscally than other cities because they could afford to pay NLC's dues. If this bias exists then the findings of the survey represent better conditions than actually prevail for cities in general.

Table 1 below provides a distribution of responses by region and by city size. In the Appendix tables provide a listing of number of cities by state within each region and a list of their names.

The survey forms were mailed between June 1, 1982 and September 30, 1982. The 1982 data are both actual and mid-year revised reports, while the 1983 data are from proposed or adopted budgets. All years mentioned will be city fiscal year unless otherwise noted.

TABLE 1

Distribution of Responses to Questionnaire

Region	North-East	South	Midwest	West	Total
Small (less than 50,000)	6	7	7	9	29
Medium (50,000-250,000)	1	10	5	11	27
Large (above 250,000)	4	6	5	8	23
Total	11	23	17	28	79

Source: Survey of Steering Committee Cities, National League of Cities, 1982

II. Trends in General Fund Revenues and Expenditures

The growth trends in general fund revenues and expenditures for the cities surveyed are not encouraging. The findings of the NLC Survey are similar to the findings reported in the most recent Joint Economic Committee survey, released September 30, 1982. In general, for all sizes of cities and in all regions of the country, NLC found expenditures growing faster than revenues by substantial margins in fiscal 1982. Furthermore, the budgeted 1983 data indicate that this trend will continue although the differential between the average growth rate of revenues and expenditures is expected to narrow from 2.4 percent in 1982 to 1.6 percent in 1983. The larger the differential the greater the fiscal stress the city is likely to experience.

TABLE 2

Growth Trends in General Fund
Revenues and Expenditures
By Region
(percent change year to year)

	Fiscal Year 81-82			Fiscal Year 82-83		
	Rev.	Exp.	Disparity	Rev.	Exp.	Disparity
Northeast	8.29	12.21	3.92	2.82	5.66	2.84
South	9.90	11.66	1.76	7.05	7.93	0.88
Midwest	6.03	7.59	1.56	5.55	7.09	1.54
West	8.99	11.60	2.61	6.70	8.62	1.92
All Cities	8.59	10.92	2.33	6.03	7.66	1.63

Source: Survey of Steering Committee cities, National League of Cities, 1982

A widely varying pattern of expenditure and revenue growth rates appears when the data are sorted on a regional basis. As expected, the region with the severest recession, the Midwest, has the lowest growth rate in revenues, however, it also has the lowest growth rate in expenditures. Specific reasons for this outcome are unclear from the study.

Another finding for which few explanations are apparent is the rapid decline in growth rates in small cities of 50,000 or less. Revenue growth will decline from 8.83 percent in 1982 to 2.08 percent in 1983. Expenditure growth will decline from 11.68 percent to 4.67 percent during the same period. The actual number of cities experiencing revenue growth rates lower than expenditure growth rates is 66 percent in 1982 and 45 percent in 1983.

TABLE 3

Growth Rates in General Fund
Revenue and Expenditures*
By City Size

	Fiscal Year 81-82			Fiscal Year 82-83		
	Rev.	Exp.	Dis-parity	Rev.	Exp.	Dis-parity
Large Cities	8.61	11.86	3.25	7.75	8.08	0.33
Medium Cities	8.33	9.43	1.10	9.21	10.86	1.65
Small Cities	8.83	11.68	2.85	2.08	4.67	2.59
All Cities	8.59	10.92	2.33	6.03	7.66	1.63

Source: Survey of Steering Committee Cities, National League of Cities, 1983

*In percent

Overall 52 percent of the cities surveyed indicated revenues grew more slowly than expenditures during 1982 and 44 percent expected an encore in 1983. The worst situation was in the Northeast where 73 percent of cities had these conditions and 63 percent expected it to continue into 1983. Two-thirds of small cities reporting had this experience in 1982 and 45 percent expected it to continue through 1983.

III. Full-Time Employment

One of the most strinking evidences of the fiscal stress faced by cities has been the continuing decline in public sector employment. The Survey of Current Business, published by the Department of Commerce, reports that for state and local government, a percent decline in full-time employment was recorded between 1980 and 1981 and a 2 percent decline was recorded so far during 1982. These findings are corroborated by the NLC Survey.

The experience of laying off employees, however, was not evenly spread among the regions of the country. The number of cities reporting increases, decreases or no change in full-time employment varied widely across the regions. Three-fourths of Midwestern cities indicated they would have to lay off employees while almost half of the Southern cities did, too. On the other hand, cities in the West indicated by a 2 to 1 margin, they were adding rather than cutting new employees. This is presented in Table 4 below.

TABLE 4

Change in Full-Time Employment
Fiscal Year 1981-1982
(by region)

		Plans to Increase	Plans to Decrease	No Change
I.	Percent of Cities Reporting			
	Northeast	30	30	40
	South	39.1	56.5	4.3
	Midwest	18.8	75	6.2
	West	61.5	34.6	3.9
	All Cities	41.3	49.3	9.3
II.	Percent Change In Employment From FY 80-81			
	Northeast	1.68	-9.53	
	South	2.28	-4.14	
	Midwest	2.29	-4.4	
	West	3.53	-4.34	
	All Cities	2.87	-4.7	

Source: Survey of Steering Committee Cities, National League of Cities, 1982

Besides the numbers of cities reducing employment, the rate of change is also important. Overall, cities increasing employment added 2.87 percent to their work force while cities reducing employment cut an average of 4.7 percent. Three regions reported similar rates of reduction, near 4.4 percent, however, reductions in the Northeast were over twice that rate, 9.5 percent.

The outlook is for more reductions in city employment in 1983. Cities planning further hiring in 1983 declined to 33 percent from 41 percent in 1982. Cities planning further reductions remained approximately the same at 48.2 percent. The rate of increase will be around 2.5 percent but the rate of decrease will drop to 2.3 percent in 1983.

IV. Actions by Cities

The slow growth in city revenues has many causes. Slow growth in tax bases, moderation of inflation, and declines in intergovernmental grants are a few. In response, cities can raise tax rates, impose new taxes, increase existing fees, and impose new fees From the survey results it is clear cities are raising taxes. In fiscal 82, NLC found that 71 percent of the cities surveyed increased existing fees and charges and 38 percent imposed new fees. Conversely only 32 percent were willing to increase property taxes and only 13 percent increased sales taxes. Table 5 shows that the preference for fees was uniform across regions and by city size. Over 70 percent of cities in the South and Midwest raised fees, and almost 70 percent of each size category of cities did likewise.

TABLE 5

Cities that Raised Service Fees - FY 1982
(Percent of Cities Responding)

By Region:	Northeast	64	By Size:	Large	76
	South	74		Medium	67
	Midwest	71		Small	71
	West	64			
	All Cities	71			

Source: Survey of Steering Committee Cities, National League of Cities, 1982

Since property and sales taxes are two of the most important taxes, a regional analysis of cities' actions on these two tax rates was done. Table 6 displays these findings. Cities in the West, as expected, showed the greatest reluctance to increase property tax rates. Generally, they are believed to have the least ability to raise rates because of state or voter imposed limitations. The next most reluctant region was the South, where 23.8 percent of the cities increased property tax rates. By comparison, over half the cities in the Midwest and almost two-thirds of the cities in the Northeast raised property tax rates. Sales taxes were even less likely to be raised than property taxes.

TABLE 6

Changes in Tax Rates 1982
(In Percent)

	Property Tax			Sales Tax		
	Increase	Decrease	No Change	Increase	Decrease	No Change
Northeast	63.6	-	36.4	20.0	-	80.0
South	23.8	-	76.2	15.0	-	85.0
Midwest	52.9	5.9	41.2	8.3	-	91.7
West	3.8	3.8	92.4	14.0	-	87.0
All Cities	32	3	65	13	-	87

Source: Survey of Steering Committee cities, National League of Cities, 1982

V. Capital Spending

High interest rates prevalent in the tax exempt bond market during most of fiscal 1981 and fiscal 1982 were major stumbling blocks for municipal capital spending plans. From the Survey of Current Business and other reports by the U.S. Department of Commerce a declining rate of spending is clearly evident. During 1981, state and local new construction spending declined by 5.5 percent and so far in 1982, it has declined an additional 3 percent. When the rate of inflation for state and local government is considered, these declines increase in real terms to over 14 percent in 1981 and close to 10 percent in 1982.

The use of municipal bonds for infrastructure was also limited during 1982. Fifty-three percent of the cities surveyed indicated they attempted to use municipal bonds during 1982 and 36 percent indicated they had to postpone issuing bonds. The recent JEC fiscal study found that over 39 percent of the total amount of bonds planned to be issued by cities surveyed had to be delayed or cancelled because of high interest rates.

Recently long-term interest rates have declined, however, additional declines are necessary to regain the tax-exempt borrowing advantage cities experienced in the 1960's and 1970's. Average interest rates are displayed on Table 7 as are the ratios of tax-exempt interest rates to corporate, or taxable, interest rates. During the 1970's, tax-exempt rates were about 65 percent of taxable rates. Currently they range between 74 percent and 80 percent. This means cities are paying higher interest costs than previously. If the 65 percent ratio still held, tax-exempt interest rates would be 1.3 percentage points lower, 9.76 percent rather than 11.06 percent, and cities would save $130,000 for each $1,000,000 of bonds issued. On November 19, 1982 this ratio was 76.4 percent.

Although long term interest rates have peaked, their decline has not been nearly as dramatic as experienced by short term interest rates. The bottom of Table 7 shows the relative rate of change that has occurred. During calendar 1981 the general obligation bond rate index climbed 32 percent but has only declined 11 percent since last year. Similarly the revenue bond rate index climbed 30 percent during calendar 1981 but has only declined a bit over 10 percent during this past year. The corporate bond index did not climb as dramatically, but also has not declined as much as tax-exempt bonds have.

TABLE 7

Trends in Municipal Bond Market Conditions

	1980	1981	3Q/1981	3Q/1982
20 Bond-General Obligation Bond Index (1)	8.73	11.56	12.49	11.06
Revenue Bond Index (1)	9.42	12.26	13.40	12.00
Corporate Bond Index (2)	12.75	15.06	15.56	15.03
Ratio:				
G.O. Bonds to Corporate	68.5	76.8	80.3	73.6
Revenue Bonds to Corporate	73.9	81.4	86.1	79.8

	Percent Change	
	1980-81	3Q/1981 to 3Q/1982
20 Bond G.O. Index	32.4	-11.4
Revenue Bond Index	30.1	-10.4
Corporate Bond Index	18.1	- 4.0

Source: *Resources in Review*. November 1982.
Survey of Steering Committee cities, National League of Cities, 1982

(1) Bond Buyer Newspaper
(2) Moody's Investors Services

IV. Conclusion

The city fiscal stress has become increasingly more well known and more understood, and yet it remains an issue of only passing national importance. Cities have for the first time, since World War II, cut spending and employment during a recession, and thus contributed to the severity of that recession. Cities have suffered under financial pressures for so long that the most elastic part of the budget, capital spending, has been overstretched, and now appears to be an increasing claim on current revenues period. Simultaneously, state and federal fiscal problems have become increasingly severe and the flow of aid between levels of governments is being reduced.

For NLC the implications are extremely important. Cities must be given greater fiscal autonomy as state aid is reduced. Cities must be protected from further reductions in intergovernmental aid as the state and federal governments try to solve their fiscal problems. Cities must insist on more effective use of federal dollars and must be constantly on guard for ways in which costs and responsibilities are transferred to cities without accompanying resources. Cities must be given greater opportunity to define more carefully the responsibilities which they rightfully have and assure that states and the federal government pick up the responsibilities that are rightfully their's.

APPENDIX I

NUMBER OF CITIES RESPONDING TO NLC FISCAL SURVEY BY REGION AND STATE

REGION	STATE	NUMBER OF CITIES
Northeast	Massachusetts	1
	Maryland	3
	Maine	1
	New Hampshire	1
	New York	3
	Pennsylvania	2
South	Alabama	1
	Arkansas	1
	District of Columbia	1
	Florida	3
	Georgia	2
	Louisiana	1
	Mississippi	2
	North Carolina	3
	South Carolina	2
	Tennessee	1
	Texas	3
	Virginia	3
West	Alaska	2
	Arizona	3
	California	9
	Colorado	4
	New Mexico	2
	Oregon	2
	Utah	2
	Washington	2
	Wyoming	2
Midwest	Iowa	2
	Illinois	2
	Indiana	1
	Kansas	2
	Miami	1
	Minnesota	3
	Missouri	1
	Nebraska	1
	Ohio	3
	Wisconsin	1
Total		79

APPENDIX II

CITIES RESPONDING TO NLC FISCAL SURVEY

Albuquerque, NM
Anchorage, AK
Augusta, GA
Baltimore, MD
Beatrice, MD
Beaumont, TX
Beaverton, OR
Brigham City, UT
Brooklyn Park, MN
Cambridge, MA
Champlin, MN
Chapel Hill, NC
Charlotte, NC
Charlottesville, VA
Cheyenne, WY
Cincinnati, OH
Colorado Springs, CO
Dallas, TX
Davenport, IA
Denver, CO
Des Moines, IA
Dover, NH
Fairbanks, AK
Fort Wayne, IN
Fort Worth, TX
Ft. Collins, CO
Gainesville, GA
Gallup, NM
Green River, WY
Greenbelt, MD
Greenville, SC
Huntsville, AL
Jackson, MS
Kettering, OH
La Habra, CA
Lewiston, ME
Little Rock, AR
Los Angeles, CA
Lynchburg, VA
Lynnwood, WA
Memphis, TN
Meridian, MS
Milwaukee, WI
Minneapolis, MN
Modesto, CA
New Orleans, LA
New York, NY
Newport News, VA
North Miami, FL
Orlando, FL
Pasadena, CA
Peoria, IL
Philadelphia, PA
Phoenix, AZ
Pittsburg, PA
Port Jervis, NY
Portland, OR
Provo, UT
Pueblo, CO
Rock Island, IL
Rockville, MD
Salina, KS
San Diego, CA
San Jose, CA
Santa Ana, CA
Savannah, GA
South Lake Tahoe, CA
Spartanburg, SC
Sunnyvale, CA
Tacoma, WA
Tempe, AZ
Toledo, OH
Trenton, NJ
Tucson, AZ
University City, MO
Washington, DC
Wichita, KS
White Plains, NY
Winston-Salem, NC

National League of Cities

Policy Working Paper

The Importance of GRS Continues and the Need for Renewal Increases

by

Francis Viscount

WP-10

January, 1983

This document contains an analysis, by city-size and region, of the 663 direct member city's responses to NLC's General Revenue Sharing Questionnaire.

TABLE OF CONTENTS

Page

List of Tables i

Preface ii

Summary iii

Purpose and Methodology 1

How Important Is GRS To Your City's Fiscal Conditions? . 4

How Are General Revenue Sharing Funds Used? 9

What Would Be The Consequences of Terminating GRS? . . . 15

Conclusion 21

Appendix A - GRS Questionnaire 22

Appendix B - Distribution of Cities By State and Region 24

Appendix C - Distribution of Responding Cities By Size and Region in Numbers and Percents 25

LIST OF TABLES

Page

Table 1 - Summary Information (population) 2

Table 2 - Summary Information (region) 3

Table 3 - GRS Receipts as a Percent of Locally-Raised Revenue FY 1982 (population) 4

Table 4 - GRS Receipts as a Percent of Locally-Raised Revenue FY 1982 (region) 5

Table 5 - Average Property Tax Rate Increase If GRS Is Terminated (population) 6

Table 6 - Average Property Tax Rate Increase If GRS Is Terminated (region) 7

Table 7 - GRS Is Only Federal Grant (population) 7

Table 8 - GRS Is Only Federal Grant (region) 8

Table 9 - Cities Use of GRS Funds (population) 9

Table 10 - Cities Use of GRS Funds (region) 10

Table 11 - Major Capital Uses of GRS Funds (population) . 11

Table 12 - Major Capital Uses of GRS Funds (region) . . . 12

Table 13 - Major Operations Funded with GRS FY 1982 (population) 13

Table 14 - Major Operations Funded with GRS FY 1982 (region) 14

Table 15 - City Actions to Compensate For Loss of GRS (population) 16

Table 16 - City Actions to Compensate For Loss of GRS (region) 18

Table 17 - Cities Reporting Lay Offs Likely If GRS Eliminated (population) 19

Table 18 - Cities Reporting Lay Offs Likely If GRS Eliminated (region) 20

PREFACE

The following report represents the final results of a survey of city officials on the General Revenue Sharing program. The survey was conducted by the Office of Policy Analysis and Development of the National League of Cities. Questions were asked on the importance of General Revenue Sharing funds relative to local revenues, the use of GRS, and the actions respondent cities would have to take to compensate for a loss of this federal assistance. The survey questionnaire was mailed to the over 1,000 cities that are members of NLC. This report analyses the 663 responses received by December 31, 1982. The survey instrument, analysis, and report were prepared by Francis Viscount, Urban Economist of the National League of Cities' Office of Policy Analysis and Development.

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Development

SUMMARY

The following report presents the findings of the National League of Cities survey of its direct member cities on the importance of General Revenue Sharing and the likely consequences, for cities, were it not to be renewed in September, 1983. Of the almost 1,100 direct member cities surveyed, over 700 responded. This report presents an analysis of the first 663 received.

The survey was designed to be of assistance to the Congress in their consideration of reenactment of the program. Three basic questions were asked: How important is GRS to your city's fiscal condition? How do you currently use GRS funds in your city? What major action would you take to compensate for the loss of GRS funds?

The major findings clearly indicate GRS is important to all cities, in all regions of the country.

1. GRS funds represent 6.63 percent of locally-raised revenue. It represents 8.93 percent for cities under 10,000 and 4.5 precent for cities over 500,000. Although its relative importance declines as city size increases, it is not insignificant for even the largest cities. It is also a larger share of local budgets for cities in the South than for cities in other regions.

2. If local property tax rates were raised to offset all GRS funds received, increases of over 23 percent would be necessary. The highest increases would be in the smallest cities and for cities in the West and South.

3. For almost one-third of the cities surveyed, GRS is their only federal grant. For cities under 10,000, this is true of 62 percent of them. On a regional basis, the distribution is fairly even, ranging between 24 percent and 35 percent.

4. Overall GRS is almost evenly split between supporting capital or operating programs. Smaller cities favor capital projects slightly, but larger cities use it more for operations. Other than in the Northeast, cities have generally favored operations over maintenance. Approximately two-thirds of cities surveyed used funds for public safety and general government, however, the other one-third is a vivid example of how cities will respond to needs if given flexibility.

5. If GRS were terminated, only 12 percent of the cities responding would raise taxes solely to offset such a revenue drop. Forty-two percent would cut services only and forty-two percent would do a combination of both raising fees and cutting services. Small cities are more likely to raise taxes as are Northeastern cities. Large cities are less likely to cut capital spending than small cities. Western cities are most likely to cut services and programs and least likely to raise taxes.

6. Approximately one-quarter of the cities responding said they would lay off personnel. Medium to large cities are most likely to lay off employees, as are cities in the West and Midwest.

GRS can thus be viewed as the glue that holds the fiscal fabric of many cities together. It is widely needed and used by cities of all sizes in all regions of the country. The result of NLC's survey make a compelling argument that the Congress should move quickly to assure its reenactment before local FY 84 budgets must be adopted.

PURPOSE AND METHODOLOGY

The National League of Cities (NLC) undertook a survey of its direct member cities during the Fall of 1982, to answer three basic questions concerning the General Revenue Sharing (GRS) program.

- How important is the program to your city's fiscal condition?
- What are the major services or types of projects financed with General Revenue Sharing funds?
- What would be the most likely consequence for your city if General Revenue Sharing were not renewed? (The current program's authorization expires September 30, 1983.)

It was anticipated that the answers to these questions would help the Congress in considering renewal of the program during the first session of the 98th Congress.

The questionnaire was mailed to the almost 1,100 direct member cities of the NLC. Over 700 responses were received. Responses were analyzed on the basis of city-size and region. A copy of the questionnaire is included as Appendix A of this report.

The only subjective question on the survey, number 6, asked cities to indicate at least one important use of GRS funds during the past year. Many cities provided more than one, but significantly over 90 percent provided at least one. When there were multiple entries, the three most significant, in terms of funds committed, were used to develop the analysis of responses.

Before describing the responses and reporting on the findings, three caveats are important. The first concerns the interpretation of regional findings. The second concerns implicit policy questions raised by the results of the survey and analysis. The third caveat relate to the extent to which responses represent a scientific sample and, the findings should be viewed as representative, rather than conclusive.

First, GRS is an entitlement program which has funds distributed automatically based upon a three or five factor formula. Basically, the formula allocates funds by considering population, wealth and tax effort. The region in which a city is located has no impact on the allocation of funds, and therefore, the regional analysis included should be considered as descriptive of program outcomes not as determining or affecting them. On the other hand, city size does influence the total GRS allocation a city receives and therefore, affects a city's answers to the survey questions.

The second caveat concerns the extent to which there are implied policy options in this study. There are none. It was the intent of the survey to present findings concerning the usefulness of the existing program, and not for cities to present a series of theoretical options for program redesign. No questions about the formula were asked, nor was any analysis undertaken. Questions concerning equity, the inclusion or exclusion of particular local taxes or changes in the program regulations were not part of the survey or analysis.

The third caveat is that responses to this survey do not constitute a scientific sample and therefore should be considered descriptive. Tables 1 and 2 provide the distribution of the city's responses used in the analysis, included average populations, entitlements and average per capita entitlement. The variations in per capita entitlements shown in table 1 are similar to distributions found in other surveys. The Northeast per capita entitlement figures in table 2 is very high. It reflects the inclusion of New York City, Philadelphia and Pittsburg, cities with high tax effort and correspondingly high entitlements and the general lack of responses from smaller Northeast cities.

TABLE 1

Summary Information

(population in thousands)

	Under 10	10 to 50	50 to 249	250 to 499	Over 500
Number of cities reporting (total = 663)	116	332	172	24	19
Average population (in thousands)	5.8	27.0	100.3	332.4	1,320.0
Average GRS entitlement (in thousands)	$104	$458	$1,619	$7,131	$33,338
Per capita entitlement (in dollars)	$18.29	$17.40	$16.14	$21.00	$25.26

Source: National League of Cities, GRS Questionnaire, Fall, 1982

TABLE 2

Summary Information

(region)

	Northeast	South	Midwest	West
Number of Cities total = 663	57	260	206	140
Average population (in thousands)	202.6	73.1	73.6	101.3
Average GRS entitlement (in thousands)	$6,441	$1,438	$1,190	$1,864
Per capita entitlement (in dollars)	$31.79	$19.67	$16.16	$18.40

Source: National League of Cities, GRS Questionnaire, Fall, 1982

However, the findings of the survey are significant because the cities included in the survey receive over one-half of the total GRS entitlements received by cities, $1.24 billion out of $2.3 billion.

HOW IMPORTANT IS GRS TO YOUR CITY'S FISCAL CONDITIONS?

Three dimensions of the fiscal value of GRS to cities were probed. Its overall importance was guaged by measuring GRS against locally-raised revenues. The second dimension concerned the effects on local property tax rates if they were increased to compensate for the loss of GRS funds. The third was whether GRS was the only federal aid the city received.

A. GRS as share of locally-raised revenues.

Tables 3 and 4 provide the city-size and regional distribution of responses to the first dimension, GRS as a share of locally-raised revenues. Overall GRS equals 6.63 percent of locally-raised revenues. This finding compares favorably to the recent Census Bureau reports that indicate GRS equals 6.7 precent of locally-raised revenues for all cities. Clearly GRS makes an important and significant contribution to local fiscal stability.

TABLE 3

GRS Receipts As A Percent Of
Locally-Raised Revenue
FY 1982
(in percent)*

(population in thousands)

Range	Under 10	10 to 50	50 to 249	250 to 499	Over 500	Total
0-.99%	1	2	1	-	-	1
1-4.99%	28	42	46	33	58	41
5-9.99%	40	43	43	58	42	43
10% +	31	13	9	9	-	15
Average	8.93	6.54	5.70	5.56	4.51	6.63

*Numbers may not add to 100 due to rounding

Source: National League of Cities, GRS Questionnaire, Fall, 1982

TABLE 4

GRS Receipts As A Percent Of
Locally-Raised Revenue
FY 1982
(in percent)

(region)

Range	Northeast	Midwest	South	West	Total
0-.99%	-	1	1	1	1
1-4.99%	58	55	24	45	41
5-9.99%	26	35	50	48	43
10% +	16	9	25	6	15
Average	5.48	5.62	8.30	5.53	6.63

Source: National League of Cities, GRS Questionnaire, Fall, 1982

The distribution of the responses is also significant. GRS is most important for the smallest cities. For almost one-third of them, GRS equals more than 10 percent of locally-raised revenues. On average it equals almost 9 percent for all cities under 10,000.

As city size increases, the share of locally-raised revenues represented by GRS decreases. However, even for the largest cities it equals 4.5 percent on average. For 43 percent of the largest cities surveyed, GRS equals over 5 percent of locally raised revenues.

On a regional basis, the findings mainly reflect the large number of small cities in the South participating in the survey. The number of large cities in the Northeast also is reflected by the fact that for 58 percent of the cities Northeast surveyed, GRS represents less than 5 percent of locally-raised revenue.

B. Local property tax rates.

Often it has been asserted that cities could tap their local property-tax base if GRS were ended. To test this assertion, cities were asked how much they would have to increase property tax rates to compensate for a loss of GRS funds. It must be remembered that local property tax bases do not change if federal programs end and therefore any increase in property tax revenues would require increases in the rate.

Responses to this question make a compelling case against such an assertion. If GRS were ended, local property tax rates for the smallest cities would need to be increased 50 percent on average. For all cities over 10,000 rates would need to increase between 23 percent and 27 percent. Table 5 summarizes these findings.

TABLE 5

Average Property Tax Rate Increase
If GRS Is Terminated

(population in thousands)

	Under 10	10 to 50	50 to 249	250 to 499	Over 500
Percent rate increase	50.73	26.13	23.70	27.58	23.11
Number of cities	100	283	140	18	16

Source: National League of Cities, GRS Questionnaire, Fall, 1982

When viewed in a regional basis the findings differ substantially. Northeastern cities indicate they would need to raise their taxes by only about 9 percent, while western cities would need to raise their rates by almost 50 percent. Midwestern cities tend to be closer to the Northeast, while those in the South tend to be closer to the West. These findings generally reflect the relative importance of the property tax in different regions of the United States, with the exception of those states where rate increases are not permitted, e.g., California, Idaho, Massachusetts, etc. Generally speaking, the South and West have lower tax rates, assessment ratios and per capita property tax bases than the Northeast and Midwest and therefore require larger rate increases to raise sums equal to GRS. Table 6 summarizes these results.

TABLE 6

Average Property Tax Rate Increase
If GRS Is Terminated

(region)

	Northeast	South	Midwest	West
Percent Rate Increase	8.87	37.05	17.75	49.77
Number of Cities	52	235	186	84

Source: National League of Cities, GRS Questionnaire, Fall, 1982

C. GRS as only grant.

General revenue sharing is particularly important for smaller communities because, for many, it is the only federal aid they receive. For cities under 10,000, 62 percent indicated GRS was the only federal grant they received. For cities between 10,000 and 50,000 population, 39 percent indicated it was their only federal grant. And for cities between 50,000 and 250,000, 5 percent of the cities indicated that it was their only federal grant. Table 7 displays these findings.

TABLE 7

GRS Is Only Federal Grant

(population in thousands)

	Under 10	10 to 50	50 to 250
Number of Cities	72	130	8
Percent of total cities reporting	62	39	5

Source: National League of Cities, GRS Questionnaire, Fall, 1982

On a regional basis, between one-quarter and one-third of cities in each region receive GRS as their only grant. Overall, 32 percent of the cities surveyed indicated GRS is their only federal grant, thus making its continuation even more critical to them. Table 8 displays this data.

TABLE 8

GRS Is Only Federal Grant

(region)

	Northeast	South	Mid-West	West
Number of Cities	17	86	73	34
Percent of total cities reporting	30%	33%	35%	24%

Source: National League of Cities, GRS Questionnaire, Fall, 1982

9

HOW ARE GENERAL REVENUE SHARING FUNDS USED?

We asked cities to name the major purposes for which they used GRS funds during the past year. The variety of programs and projects was a real reflection of the program's flexibility. Some of the more diverse ones included downtown revitalization, senior citizen programs, meals on wheels, public facility access improvements for the handicapped, shared taxi, supplemental income for indigents, and aiding community based action agencies.

Although there were substantial numbers of cities which used GRS liberally in both capital and operating programs, two trends with respect to city size were apparent. As the size of cities increases there is a tendency not to use GRS wholly for capital projects. Over one-third of cities under 10,000 used GRS wholly for capital projects, while no city over 500,000 did and only 8 percent of the cities from 250,000 to 500,000 did.

A reverse trend was true for operating programs. The larger the city the more likely it would allocate its funds solely to operating programs. Seventy-nine percent of the cities with populations over 500,000 allocated their funds to operations while only 29 percent of those with populations under 10,000 did. Table 9 displays these data.

TABLE 9

Cities Use of GRS Funds
(in percent)

(population in thousands)

	Under 10	10 to 50	50 to 249	250 to 499	Over 500	All Cities
Capital only	36	26	16	8	-	24
Operations only	19	29	44	54	79	33
Both	45	45	40	38	21	43

Source: National League of Cities, GRS Questionnaire, Fall, 1982

On a regional basis the pattern of answers does not provide clear trends. The Northeast cities, which tend to have infrastructure in place and higher levels of tax effort, exhibit a preference for supporting operations rather than making capital improvements with GRS and thus hold down tax rates. The reverse is generally true in the South. The Midwest exhibits a slight bias toward operating expenditures but the West shows the opposite. The answers from Western cities appear to reflect the fiscal pressure created by the various tax and expenditure limitations that have been enacted in those states. Table 10 displays these results.

TABLE 10

Cities Use of GRS Funds
(in percent)*

(region)

Use	Northeast	South	Midwest	West	Total
Capital only	9	32	21	19	24
Operating only	61	22	29	49	33
Both	30	46	50	31	43
percent capital	45.2	55.7	57.8	56.8	-
percent operating	48.4	40.9	36.8	39.8	-

*Numbers may not add to 100 due to rounding

Source: National League of Cities, GRS Questionnaire, Fall, 1982

A. Capital programs.

The variety of use of GRS funds in capital programs is substantial. Cities bought administrative computers and communication facilities, paved streets, funded local public transit and revitalized their downtowns. Tables 11 and 12 provide a glimpse of the numbers of cities by size and region that used GRS funds for capital expenditures. Smaller cities tended to be more innovative than larger cities. On a regional basis no divergent patterns were apparent.

TABLE 11

Major Capital Uses of GRS Funds
FY 1982
(in percent)

	Under 10,000	10,000 to 50,000	50,000 to 250,000	250,000 to 500,000	Over 500,000
Economic development	14	7	8	-	-
Meet federal requirement	3	1	3	-	-
Street repair	29	34	32	50	-
Transit	2	5	6	10	-
General capital*	53	53	51	40	100

Numbers may not add to 100 due to rounding

*Includes parks, land, buildings and major equipment

Source: National League of Cities, GRS Questionnaire, Fall, 1982

TABLE 12

Major Capital Uses of GRS Funds
FY 1982
(in percent)

(regions)

	Northeast	South	Midwest	West
Economic development	-	11	9	3
Meet federal requirements	-	2	2	2
Street repair	42	36	32	28
Transit	5	2	7	5
General capital*	53	50	50	62

Numbers may not add to 100 due to rounding

*Includes parks, land, buildings, major equipment

Source: National League of Cities, GRS Questionnaire Fall, 1982

B. Operating programs.

The value of the flexibility of GRS funds is apparent by the range of operating programs supported with them. A great number of human needs are met with these funds. Cities of all sizes commit substantial funds to senior citizens, alternative transit programs, social services and emergency relief, and external community-based social service agencies. On the basis of city size, generally one-third of all GRS is used for these programs, while two-thirds is used to support general government and public safety activities. Table 13 summaries these answers.

TABLE 13

Major Operations Funded with GRS
FY 1982
(in percent)

(population)

	Under 10,000	10,000 to 50,000	50,000 to 250,000	250,000 to 500,000	Over 500,000
Alternative transit	2	3	1	-	-
Health	5	6	5	3	17
Recreation	8	7	7	10	3
Senior citizens	10	9	9	7	3
Social services	8	11	11	11	14
Public safety	39	40	50	41	31
General government*	28	24	17	28	31

Numbers may not add to 100 due to rounding

*Includes administration, planning, sanitation, transportation

Source: National League of Cities, GRS Questionnaire, Fall, 1982

On a regional basis, three of the four regions exhibit this similar pattern. However, Northeastern cities spend 82 percent of these funds on public safety and general governmental functions. This reflects the generally higher amount of fiscal stress found in Northeastern cities which makes them the most vulnerable to termination of GRS. Table 14 displays these findings.

TABLE 14

Major Operations Funded With GRS
FY 1982
(in percent)

(region)

	North-east	South	Mid-west	West
Alternative transit	2	1	5	1
Health	2	8	5	6
Recreation	3	8	5	7
Senior Citizens	3	5	16	9
Social services	8	9	11	15
Public safety	42	42	39	49
General government*	40	27	21	13

Numbers may not add to 100 due to rounding

*Includes administration, planning, sanitation and transportation

Source: National League of Cities, GRS Questionnaire, Fall, 1982

WHAT WOULD BE THE CONSEQUENCES OF TERMINATING GRS?

The questions in this section of the questionnaire explored two aspects of how cities would adjust to the loss of GRS funds, how they would adjust their budgets and if they expected to lay off personnel. Budget options are rather limited. Cities can cut spending, raise revenue or do both. Cities could spend down surpluses or borrow in the short term, but ultimately they must make more permanent policy decisions. Related to expenditure reductions is the likelihood of lay off because in most cities around 70 percent of operating costs are for personnel.

Overall cities indicated that most of the loss of GRS funds would be quickly followed by service cutbacks. Only 12 percent of the cities surveyed indicated a willingness to raise fees and taxes to completely offset the loss of GRS. On the other hand 42 percent of the cities indicated they would rely solely on capital and operating budget cuts to offset the loss of GRS. The bulk of the remaining cities said they would do a combination of both revenue increases and expenditure cuts. The survey did not ask about the precise mix of this latter course, however, it is reasonable to surmise that over half the loss of revenue will result in service reductions, particularly during these bad economic times.

The subsequent two tables present the actions cities intend to take if GRS were to end. Table 15 displays those choices by city-size. From the responses, three general findings can be drawn. The smaller the city the more likely it will consider raising taxes to compensate for a loss of GRS. Almost three times as many small cities considered this their most likely response. A second finding is that fewer large cities will reduce capital expenditures than will small cities. In fact as population increases the ability to reduce capital spending decreases.

TABLE 15

City Actions to Compensate For Loss of GRS (in percent)*

(population in thousands)

	Under 10	10 to 50	50 to 249	250 to 499	Over 500	Total
Increase taxes	18	10	10	-	5	11
Increase fees	-	1	1	4	-	1
Reduce capital expenditures	27	32	21	17	5	27
Reduce operating expenditures	8	14	19	17	21	15
Increase revenue and cut spending	40	41	43	58	47	42
Use reserves	4	1	2	-	-	2
Increase debt	1	-	1	-	-	-
Other	2	1	4	5	5	2

*Numbers may not add to 100 due to rounding

Source: National League of Cities, GRS Questionnaire, Fall, 1982

A similar pattern appears when cutting both capital and operating programs is the preferred response. Forty-six percent of cities between 10 and 50 thousand would offset a loss of GRS solely with spending cuts, but only 26 percent of the largest cities believe they can do the same.

The most prominent choice for all cities is a combination of raising revenue and reducing expenditures. However, it is likely that cities contemplate mostly increasing fees rather than taxes to raise revenue. This would be consistent with the findings of various fiscal surveys recently conducted, including NLC's, in which raising fees and charges was twice to three times as popular for raising local revenues as was raising taxes. However, because fees are still a small share of total city budgets, it is likely that there will need to be more dollars of service reductions than increases in revenue.

Table 16 provides a regional distribution of responses. The two most striking findings are that relatively more cities in the Northeast would be compelled to raise taxes to offset the loss of GRS than in any other region. Almost one-third of the Northeastern cities would not be able to reduce services and programs further than they currently have. Only 14 percent of the Northeastern cities indicate they would balance their budgets with program and service cuts. This clearly indicates the fiscal dilemma facing these cities, but this is consistent with the survey finding that Northeastern cities use the greatest share of GRS for basic services, general government and public safety.

TABLE 16

City Actions to Compensate For Loss of GRS (in percent)*

(region)

	Northeast	South	Midwest	West	Total
Increase taxes	30	10	9	6	11
Increase fees	2	-	2	1	1
Reduce capital expenditures	7	29	27	33	27
Reduce operating expenditures	7	9	18	25	15
Increase revenue and cut spending	53	49	39	32	42
Use reserves	2	2	2	1	2
Increase debt	-	-	2	-	-
Other	-	2	2	3	2

*Numbers may not add to 100 due to rounding

Source: National League of Cities, GRS Questionnaire, Fall, 1982

Alternatively, Western cities, under the burden of many tax and expenditure limits, indicate they are least able to raise taxes and over half, 58 percent, of the cities must rely solely on expenditure cuts to offset a loss of GRS funds. One-third of Western cities indicate capital spending would be cut, a particularly painful decision since the population growth in the West continues to require additions to existing capital stock.

The cities of the Midwest and South regions array themselves close to the overall averages, however, this means significant cuts in services and limited ability to raise taxes to offset the loss of GRS.

The second dimension of how cities would respond to the end of GRS concerns whether they would lay off municipal employees. Of the total number of cities reporting, 174, or 26 percent, indicated that they would have to lay off employees. These cities were from every population group and region. Generally, as the population of cities increased, the number of cities estimating that they would need to lay off employees increased. Strikingly, half the cities between 250 and 500,000 thought lay offs would occur if GRS ended. Similarly, as the size of the city increased the average number of lay offs also increased. For cities under 10,000, the average number of lay offs estimated was five; while, for cities between 250,000 and 500,000, the average number of lay offs approached 189. These figures are summarized in Table 17.

TABLE 17

Cities Reporting Lay Offs Likely If GRS Eliminated

(population in thousands)

	Under 10	10 to 50	50 to 249	250 to 499	Over 500	Total
Number of cities	24	86	47	12	5	174
As a percent of total cities reporting	21	26	27	50	26	26
Average number of lay offs	5	16	57	189	698	-

Source: National League of Cities, GRS Questionnaire, Fall, 1982

The regional distribution of cities expecting lay offs also contains some surprises. Because of the recession a high rate of lay offs in the Midwest would be likely and this was found. However, that rate was matched by cities in the West. The average number of lay offs is actually close between these two regions, 51 employees in the Midwest and 43 in the West.

The number of Southern and Northeastern cities anticipating needing to lay off if GRS ends is quite similar, 20 percent and 18 percent respectively. However, the average number of lay offs in the South is three times the number in the Northeast. These figures are on Table 18. This is consistent with the earlier finding that Northeast cities would be least able to cut services if GRS funds stopped coming.

TABLE 18

Cities Reporting Lay Offs Likely If GRS Eliminated

(region)

	North-east	South	Mid-west	West	Total
Number of cities	10	52	66	46	174
As a percent of total cities reporting	18	20	33	33	26
Average number of lay offs	27	83	51	43	-

Source: National League of Cities, GRS Questionnaire, Fall, 1982

CONCLUSION

These results clearly indicate the importance of revenue sharing and the very difficult actions cities would have to take to compensate for the loss of these funds. Revenue sharing has become in many ways the glue that holds the precarious fiscal situation of many cities together. Existing resistence to higher taxes would ensure that important services would have to be reduced, capital spending for infrastructure postponed and municipal employees laid off. These findings dramatize how GRS is important to all cities and the need for Congress to ensure reenactment of the program early in its current session.

APPENDIX A

NATIONAL LEAGUE OF CITIES
GENERAL REVENUE SHARING QUESTIONNAIRE

RETURN TO:
National League of Cities
Office of Policy Development
1301 Pennsylvania Avenue, N.W.
Washington, D.C. 20004

BY OCTOBER 8, 1982

CITY OF ______________

STATE ______________

CONGRESSIONAL DISTRICT(S)__

____

POPULATION______________
(Figure reported for GRS Entitlement Period #14)

ENTITLEMENT FOR EP #14 $____

____

FISCAL YEAR BASIS ________
(e.g., July-June)

I. GRS and City Budgets

1. What percent of general tax supported/own-source city revenues (excluding enterprise and education functions) did GRS funds represent in your City's budget for:

   a. Current Fiscal Year?____ ______________%

   b. Fiscal Year 1977?______ ______________%

2. If your current GRS entitlement were eliminated and had to be raised from property taxes, it would raise the current rate by ________ percent.

3. Check here if your City receives no federal funds directly other than GRS funds. ___

II. Use of Funds

4. Approximately ________ percent of your City's current GRS entitlement is spent for capital outlays which include construction ($10,00 or greater per project), purchase of equipment having an expected life of five years or more, and purchase of land.

5. Approximately ________ percent of your City's current GRS entitlement is spent for operating and maintenance outlays.

NOTE: Please explain if answers to #4 and 5 above do not add to 100%:

____

GENERAL REVENUE SHARING QUESTIONNAIRE

6. Describe on separate sheets at least one example of how your City has used GRS funds to provide important community services and facilities in the past year. Use narrative descriptions being careful to include details, such as dollars spent, where appropriate.

III. Consequences of GRS Termination

7. If all GRS funds were terminated on October 1, 1983, which one statement below best describes the action your City would take?

___a. Increase property or other taxes.
___b. Increase or institute service fees and charges.
___c. Reduce or defer capital expenditures.
___d. Reduce operation and maintenance expenditures.
___e. Increase taxes and/or service fees and reduce expenditures.
___f. Use surplus or other reserve funds.
___g. Increase debt.
___h. Other (please explain) ______________________.

8. If your answer to #7 above would entail layoffs of full-time permanent personnel, estimate the number. __________________

Compiled by ________________________ Title __________________

Phone # _____ __________________

Thank you for assisting in this effort to bring about renewal of this important program.

APPENDIX B

DISTRIBUTION OF CITIES BY STATE AND REGION

	Northeast		South		Midwest		West	
	CT	9	AL	19	IA	15	AK	4
	DE	2	AR	5	IL	41	AZ	8
	MA	1	DC	1	IN	9	CA	61
	MD	10	FL	40	KS	20	CO	17
	ME	2	GA	23	MI	28	ID	1
	NH	2	KY	13	MN	18	MT	2
	NJ	7	LA	21	MO	15	NM	5
	NY	10	MS	10	ND	4	NV	4
	PA	5	NC	45	NE	8	OR	13
	RI	5	OK	10	OH	33	UT	8
	VT	4	SC	10	SD	6	WA	10
			TN	16	WI	9	WY	7
			TX	33				
			VA	10				
			WV	4				
Totals		57		260		206		140

APPENDIX C

DISTRIBUTION OF RESPONDING CITIES BY SIZE AND REGION, IN NUMBER AND PERCENT

(region)

City Size	Northeast	South	Midwest	West	Total
Less than 10,000	9	73	19	15	116
10,000-49,999	30	114	128	60	332
50,000-249,999	14	54	49	55	172
250,000-499,999	2	11	5	6	24
Over 500,000	2	8	5	4	19
Total	57	260	206	140	663

(percent)

City Size	Northeast	South	Midwest	West	Total
Less than 10,000	15.8	28.1	9.2	10.7	17.4
10,000-49,999	52.6	43.8	62.1	42.9	50.0
50,000-249,999	24.6	20.8	23.8	39.3	25.9
250,000-499,999	3.5	4.2	2.4	4.3	3.6
Over 500,000	3.5	3.1	2.4	2.9	2.9

Source: National League of Cities, GRS Questionnaire, Fall, 1982

Senator Dave Durenberger

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FACT SHEET
on S.41:
State and Local Fiscal Assistance Act Amendments of 1983

Provisions:

-- The bill is a simple reauthorization of the General Revenue Sharing program, retaining the funding level of $4.6 billion per year for three years.

-- It also retains the current allocation formula, which takes into account a community's population, per capita income and tax effort.

-- The reauthorization would become effective on Oct. 1, 1983, the first day of FY 1984. The present program expires Sept. 30, 1983.

Revenue Sharing facts:

-- General Revenue Sharing funds are paid quarterly, five days after the end of each quarter.

-- To be eligible, a local government must qualify as a unit of general government as defined by the Census Bureau. Special purpose districts, such as school districts, are not eligible.

-- More than 39,000 units of local government are eligible, including counties, cities, towns, townships, municipalities, Indian tribes and Alaskan native Americans.

-- Minnesota communities, for example, received more than $85 million in General Revenue Sharing funds in FY 1982, and are expected to receive some $85 million in FY 1983.

-- The program comprised only about 5.5 percent of total federal grant funding in FY 1981.

-- The program's administrative costs total only about .1% of funds distributed.

-- Revenue Sharing is an "entitlement" program, meaning that no application is necessary to receive funds. Eligible governments must only return a simple form which they automatically receive.

-- Recipient governments must ensure compliance with comprehensive civil rights provisions and the Davis-Bacon Act in use of the funds, but there are no "strings" specifying how the money is to be used.

History:

-- Revenue Sharing originally was conceived as a way of sharing the Federal income tax with state and local governments. (The present system, however, relies upon an appropriation from general revenues.)

-- Its major purpose is to distribute Federal assistance to governments with maximum flexibility of use.

-- The program originated in the State and Local Fiscal Assistance Act of 1972, which authorized the distribution of $30.2 billion over five years.

-- General Revenue Sharing has since been reauthorized twice, in 1976 and 1980.

-- State governments have not participated since 1980, when changes in the Act effectively eliminated states from the program.

-30-

Senator Dave Durenberger
U.S. Senator for Minnesota

FACT SHEET
on
S.700:
EXPANDED REVENUE SHARING PROGRAM

The proposal builds upon and expands the current General Revenue Sharing program. Its major provisions:

- -- State governments would be brought back into the program;
- -- The state funding would be allocated so as to ease fiscal disparities among the states;
- -- The local portion of the program would be slightly increased, with improvements added to achieve more equity in the allocation of local funds;
- -- No local government would receive any less funding under the revised revenue sharing program than it would under the current program;
- -- Revenue sharing funds would be supplied by an earmarked percentage of Federal income tax collections; and
- -- The increased cost of the program would be partially funded by increased revenues from a tax reform measure, which alters the deductibility of state and local taxes on the Federal income tax.

Specific features of the bill:

1. A Revenue Sharing Trust Fund would be created, into which would be permanently appropriated 4 percent of the federal individual income tax. The size of the program would thus be $11.8 billion in FY 1984.

The state share of the Trust Fund initially would be $5.9 billion and the local share $5.9 billion. Thereafter, the size of the Trust Fund would increase with the growth in Federal income tax receipts.

2. Allocations would be made from the Trust Fund among the states by a formula based partially upon fiscal capacity -- a state's ability to raise its own revenues.

3. Allocations among local governments would be based upon the current three-factor formula (population, per capita income and tax effort), with certain modifications:

a. The formula would be "de-tiered" in line with recommendations by GAO. Currently, local funds are distributed in three steps: to states, then to geographic "county areas," and then to local governments within those areas. This may cause localities with identical needs to receive very different amounts of aid, depending upon the county areas in which they are located. Under the new approach, the funds would go directly from states to local governments, eliminating these inequities.

-OVER- 23-306-02

b. The maximum and minimum constraints would be adjusted. Currently, no jurisdiction can receive, per capita, more than 145 percent of the per capita state allocation, and no less than 20 percent of the per capita state allocation. (For example, if a state receives the equivalent of $20 per capita in local revenue sharing funds, no one jurisdiction can receive any more than $29 per capita or less than $4 per capita.)

Under the change, the per capita maximum would be raised from 145 percent to 175 percent, and the minimum lowered from 20 percent to 15 percent. Giving the formula freer rein will help target funding to distressed areas.

c. The fixed budget constraint would be replaced by a variable budget restraint. Currently, the fixed budget constraint works like this: A jurisdiction's budget is considered to be its own-source revenues plus its Federal and state aid; its revenue sharing allocation can equal no more than 50 percent of its budget.

This constraint effectively knocks "toy governments" out of the program -- governments that basically exist only on paper -- but it also hurts some very real, but very poor governments. An improvement would be a variable constraint linked to the jurisdiction's fiscal capacity.

d. The de minimus -- the minimum allocation that can be given to a jurisdiction -- would be increased from $200 to $500.

e. Indian tribes would be considered a discrete category of revenue sharing allocation, rather than receiving part of the state or local share.

f. Tax enclaves would be defined and addressed. The allocation formula considers tax effort as a measure of need, but this can be misleading: sometimes high tax effort means a community has more wealth, not less. For example, a jurisdiction can get heavy taxes from a large industrial complex or nuclear plant in an area with few or no residents. Such tax enclaves would be defined within the allocation system, and the measure of their tax effort capped.

g. Hold-harmless provisions would guarantee that each local government would receive no less than it would have gotten under the current General Revenue Sharing program. The hold-harmless provisions would be funded out of the state share. As the size of the program grows in future years, the amount of money needed to satisfy these provisions would steadily decrease until eventually they would cease to constrain the formula.

4. The deduction of state and local taxes on the Federal income tax would be limited in this manner: The taxpayer's state and local taxes (income, sales, real property and personal property) would be pooled into one figure; only the portion of that figure exceeding 1 percent of the taxpayer's adjusted gross income would be deductible. Example: A taxpayer making $10,000 per year in the 14% tax bracket would pay another 14 dollars in taxes. A taxpayer with an adjusted gross income of $100,000 in the 50% bracket would pay another $500 in taxes.

-30- 23-36-03

S.700:
FACT SHEET
on
"TAX POOLING"
and
DEDUCTIBILITY OF
STATE AND LOCAL TAXES

Originally, virtually all taxes paid by an individual -- including the Federal income tax itself -- were deductible from the Federal income tax. Gradually, Congress realized that deductibility of many of these taxes was unjustified. In 1917 Congress eliminated deductibility of the Federal income tax; in 1943, of all Federal excise taxes; in 1964, of state and local excise taxes on tobacco, alchohol, automobiles, driver's license fees and certain other excise taxes; and in 1978, of state and local taxes on gas.

Congress continues to examine the deductibility of state and local taxes for possible limitations. The Senate Finance Committee last year looked at several proposals, such as elimination of the deductibility of state sales taxes.

Further limitations are inevitable. The question remaining is whether or not the form these limitations take appropriately reflects a concern for state and local governments, while accomplishing the necessary broadening of the tax base.

Repealing the deductibility of one particular state or local tax would have undesirable effects. For example:

Property taxes: These are the taxes most subject to competition among jurisdictions. Eliminating their deductibility would remove an important buffer to harmful competition among local governments, where "voting with the feet" is an easy option for taxpayers. Local governments are also hardest pressed to maintain their tax bases in competition with state and Federal governments.

Sales taxes: There is tremendous variation among the states in their dependence on the sales tax as a revenue source. Selectively repealing this deduction would penalize citizens who happen to live in states that don't have to rely on sales taxes because of other available revenue sources such as severance taxes or income taxes. It would aggravate tax burden disparities.

Selective repeal of deductibility would also be an improper intrusion in state and local fiscal matters. Congress has expressed its intent not to influence state and local governments in their choices of major revenue sources. Yet, if sales taxes, for example, were no longer deductible, it is likely that state and local governments would turn to the deductible forms of income and property taxes in place of the sales tax.

Tax Pooling

The concept of "tax pooling" avoids these pitfalls. This proposal pools the taxpayer's state and local taxes -- income, sales and property taxes -- into a lump sum. A floor deduction is set. Below this floor level, the taxes in the pool are not deductible; taxes above the floor level continue to be deductible.

The floor deduction should be expressed as a percentage of adjusted gross income, rather than as a fixed dollar amount, to assure that it is progressive taxation. A proper level would be 1 percent of adjusted gross income. This genuinely broadens the tax base without damaging intergovernmental objectives or overburdening the taxpayer.

The notion behind this approach is that everyone should experience the effects of base-broadening up to some point, and that relief should be granted for payments in excess of that basic amount.

This is how it works for three theoretical taxpayers:

1) Joe College

adjusted gross income (AGI)	$10,000
1% floor deduction	x .01
taxable amount	$ 100
example tax bracket: 14%	x .14
additional taxes	$ 14

2) Bob Business

AGI	$30,000
1% floor deduction	x .01
taxable amount	$ 300
example tax bracket: 30%	x .30
additional taxes	$ 90

3) Elsie Executive

AGI	$100,000
1% floor deduction	x .01
taxable amount	$ 1,000
example tax bracket: 50%	x .50
additional taxes	$ 500

This approach would raise an estimated $4.7 billion in FY 1984, and an estimated $6 billion in FY 1985.

STATEMENT OF MAYOR EDWARD I. KOCH

Senator Durenberger, members of this distinguished Subcommittee, it is my pleasure to appear before you in support of the General Revenue Sharing Program—a program that is of great importance to local governments.

Whether we represent states, counties, cities, towns or villages, the problem is the same. We have been faced with national conditions that have caused expenses to rise faster than revenues—simply stated, we have found it difficult to balance our budgets—which in virtually every locality including New York is mandated by law. All across the country we see increasing evidence that the policies of this Administration are creating havoc for local governments.

These are difficult times for all of us. New York City, like other localities and states across the nation, faces fiscal constraints of unusual severity. New York City has lost over $800 million in Federal revenues in the last two years. From our own resources, we have provided almost $300 million in order to maintain such essential services as day care centers, senior citizen centers, health care and education. Because of Federal budget cuts and the deep recession, our slow but steady progress since 1957 in restoring essential services has been constrained.

Since the adoption of a balanced budget last June for the City's fiscal year 1983, we have had to solve a $2 billion problem for fiscal years 1983 and 1984. The City's outlook has brightened since January. A series of actions such as the State Legislature's appropriating funds that would provide fiscal relief to counties which reduces the local share of Medicaid; passage of the Emergency Jobs Bill (Public Law 98–8); and a modest upturn in revenue have helped us to achieve a balanced budget for 1984. This is despite increases in mandated costs for prisons, shelters for the homeless, and Medicaid—many of these spending needs were created by the recession.

I would like to commend Senator Durenberger for his prompt action in introducing S. 41, and to speak in support of the General Revenue Sharing Program.

While the President has endorsed a simple extension of the State and Local Fiscal Assistance Act of 1972, more aid is needed. I believe that a bill which would increase the allocation to localities is needed.

Let me tell you why localities need more unrestricted aid.

State and local governments across the country are reducing their work forces in essential areas. Federal budget cuts and the recession, which Federal policies helped induce, are responsible for many of these reductions.

Our reduced capacity to hire adds to the unemployment problem just as surely as a plant closing. Thus, we add to the City's unemployment problem and to the human misery of unemployment as well as to our service delivery problem.

The best jobs program would be one which enables local governments to retain these essential workers. Their value to us has passed the market test: when we could afford them we voluntarily paid for them and taxed ourselves to do so. The jobs would not be "make-work" or "dead-end."

It makes no sense to fund "jobs" programs which would have us hire people to do jobs that are not our highest priority or to deliver services that are not our highest priority. It is nonsense to get money to spruce up public buildings when our physical plant is falling apart and we cannot afford enough operating and maintenance staff. It is difficult to hire public services employees when a locality is faced with lay-offs or attrition in such areas as cops, sanitation personnel, and teachers.

The best help we could get would be from an expanded general revenue sharing program. The funds are totally flexible and each locality can meet its highest priority needs.

Such a bill would provide needed jobs, both at the state and local level. It would help reduce the size of layoff and attrition programs and help maintain essential services in all localities.

The appropriations should be increased. Except for a small increase in 1976, the level of funding has remained constant since 1972. The Consumer Price Index (CPI) has risen by 130 percent over the same period. In other words, an increase such as the one proposed in H.R. 1930 only accounts for $1 out of every $8 that prices have risen over the same period.

In 1972, a New York City cop's base salary was $11,000. Today it is $20,195, an increase of 84 percent, 46 percent less than the increase in the CPI over the same period. In 1972, we could pay the base salary of 20,000 cops with our revenue sharing money; today we could only afford 13,000.

In 1978 our local share of Medicaid was about $500 million; in fiscal year 1984 it will be $1.1 billion, an increase of 55 percent.

In 1978 New York City received $305 million in revenue sharing funds; today we receive $271 million. The House bill would provide us with more than $40 million, or the equivalent of the base salary of 2,000 cops.

Let me suggest an amendment to the current program—one that does not involve a change in the basic formula. The cap on localities is an unfair burden on those localities, like New York City, that exercised its tax effort. If the 145 percent local per capita allocation cap within each State share were raised to 160 percent—New York City could receive, under current funding levels, about $30 million more. In other words, the basic revenue sharing formula entitles New York City to receive almost $301 million. The cap reduces this to $271 million and redistributes $30 million to other localities in New York State. I understand that other cities in other states face a similar but not as great a problem with the cap. It is unfair to restrict the amount that a locality is otherwise entitled to receive from the formula. As a result of this "cap" imposed by the Federal formula, New York City is unfairly penalized in comparison to other localities within New York State. Because of the "cap", $55 million in revenue sharing aid has gone to other localities in the State instead of the City in prior years. Without taking a dollar from another state, New York City could immediately receive up to $30 million more revenue sharing dollars by this change.

I am also pleased that S. 700 restores the State entitlement, although I am concerned about the mechanics of funding. Three years ago, when Congress made the State share subject to annual appropriations, most states were in surplus. Today states face the same difficult times that cities and counties do. Tax increases, layoffs and reductions in aid to localities as well as service reductions have become commonplace. According to a survey by the National Governors' Association, the sum of the ending balances of all states in 1980 was $11.8 billion; in 1983 it will be less than $2 billion. This clearly illustrates the trend that the recession and Federal aid reductions have had on state spending.

My concern about the State share is the Trust Fund established from increased revenues from the elimination of the State and local tax deduction for Federal Personal Income Tax purposes. Elimination of the deduction would be a disaster for both New York State and New York City. New Yorkers in the highest tax brackets would be encouraged to move to other states by a drastic increase in their total tax liability. Since we also impose taxes on non-residents who work in New York, business would also be encouraged to move to states that do not impose such taxes.

The recession and Federal budget cuts have forced many states and localities to raise taxes to maintain balanced budgets and to compensate selectively for Federal budget cuts. Like it or not, the heart of the New Federalism philosophy has been to reduce Federal taxes and Federal spending and leave to other levels of government the choice of raising taxes or cutting services. We did both in New York City. It is unfair for the Federal government to have the best of all alternatives, and enact a measure which, in effect, would punish residents of localities that have been willing to tax themselves.

I am also concerned about the proposed formula change in S. 700. The substitution of key elements of the current formula—tax effort and tax capacity—by the representative tax system. This would change the basic concept of revenue sharing. Now those States and localities who exercise their tax effort and tax capacity are rewarded. That was the intent of the program. Under S. 700 that would change. New York would be penalized. However, if you retain the tax effort element and substitute representative tax effort for tax capacity a fairer result could be achieved. Currently personal income is used as the measure for tax capacity.

Another proposal, S. 908, relates to the need for a countercyclical program. While a countercyclical program as appropriate in 1976 and 1977, it would not be an appropriate stimulus now that the economy is starting to recover. There is also a great deal of debate on the type of formula that should be used to distribute the funds. I suggest that any funds that would have been provided for a countercyclical assistance program be used to increase General Revenue Sharing funds.

I urge you to amend S. 41 to incorporate these recommendations which would ensure a dependable and predictable revenue source for states and localities for another five years.

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